No. 91-628

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Supreme Court of the United States

OCTOBER TERM, 1991

CHARLES S. and BARBARA LERMAN,
JOSEPH L. and EVELYN FRAITES,
and DWIGHT B. and JOANNE V. MASSEY,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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Questions Presented

Whether, when the Congress enacts a statute of solely retroactive character in order to clear the docket of the Tax Court and Internal Revenue Service audit division of thousands of cases involving the question of the validity of so called "commodities tax straddles," by providing all encompassing rules for the treatment of pre-1981 investor or dealer straddle transaction, the Courts may avoid application of the per se rule enacted by Congress by examining the merits of each transaction on a case by case basis, which is precisely what Congress wished to avoid in its attempt to resolve the cases without further judicial intervention.

Parties in the Court of Appeals

Petitioners, Charles S. Lerman, Barbara Lerman, Joseph L. Fraites, Evelyn Fraites, Dwight B. Massey and Joann V. Massey respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit entered in this proceeding on July 18, 1991. Respondent is the Commissioner of Internal Revenue.

Table of Contents

Questions Presented..... i

Parties to the Proceeding..... ii

Table of Authorities..... iv

Citation of Opinion Below..... 1

Jurisdiction..... 2

Constitutional and Statutory Provisions Invoked..... 3

Statement of the Case..... 5

Reasons for Granting the Writ..... 11

Conclusion..... 55

Appendix..... A1

TABLE OF AUTHORITIES

CASES

Cook v. Commissioner, 90 T.C. 975 (1988) 38, 39, 49

DeMartino v. Commissioner, T.C. Memo, 1986-263 . . . . . 50, 52, 53

Enrici v. Commissioner, 813 F.2d 293 (9th Cir. 1987) 54

Forseth v. Commissioner, 85 T.C. 127, 149 (1985), affd. 818 F.2d 293 (9th Cir. 1987) 54

Fox, et al., v. Commissioner, T.C. Memo 1988-50 1

Glass v. Commissioner, 87 T. C. 1087 (1986) 21, 39, 51

Gregory v. Helvering, 293 U.S. 465 (1935) 13, 14, 38

Jarecki v. G.D. Searle & Co., 367 U.S. 303 (1961) 43

Lerman, et al., v. Commissioner, 939 F.2d 44 (1991) 1

Mahoney v. Commissioner, 808 F.2d 1219 (6th Cir. 1987) 54

Miller v. Commissioner, 84 T.C. 827, 855 (1983) 21, 25, 29, 32, 45

Sochin v. Commissioner, 843 F.2d 351 9th Cir. 1988) 54

United States v. Turkish, 623 F.2d 769 (2nd Cir. 1980) 53

STATUTES

Section 108 Tax Reform Act of 1984, as amended . . . . . passim

26 U.S.C. § 165(c)(2). 25, 30

26 U.S.C. § 7482(a)(1) 2

28 U.S.C. § 1254(1) 2

Economic Recovery Tax Act of 1981 (ERTA) . . . . . passim

MISCELLANEOUS

"Mrs. Gregory's Grandchildren: Judicial Restrictions of Tax Shelters," 5 Va Tax Rev. 825 (1988) 14

127 Cong. Rec. Part B, p. 3673 (March 5, 1981) 19

Commodity Exchange Act, 7 U.S.C. Section 6c(a)(A), and Regulation Section 1155.2(f) of the Commodity Futures Trading Commission, 17 C.F.R. Section 155.2(f), CCH Commodity Futures Law Reporter, Par. 3182 48

Conference Committee Report on Pub. L. No. 99-514, Section 1808 (d), 100 Stat. 2085, 2817 (1986) 19, 32

Cong. Rec. S. 8390 (Daily Edition, June 27, 1984) 22

Congressional Record of July 24, 1984 (12 Cong. Rec. E. 3251) . . . 25

Proposal for Tax Treatment of Commodities Straddles and Related Transactions (Cong. Rec. Vol. 126, Part 3, pp. 3674-3676) 18

Senate Report No. 97-144. 19

Remarks of Sen. Ottinger, Cong. Rec., July 24, 1984, p. 3251. 24

House Rep. No. 99-426, 1986-3 C.B. (Vol 2) 911). 31

Re-examining the Nature and Role of Tax Legislative History in light of the Changing Realities of the Process, by Lubick, Hickman and Ferguson, a paper delivered at the Forty-Second Annual Federal Tax Conference of the University of Chicago Law School, reprinted in Taxes, the Tax Magazine, Dec. 1989, Vol. 67, No. 12, P. 814, Fn. 19 . 37, 42, 43

Revenue Ruling 77-185, 1977-1 C.B. 48 (1977) 6, 27

Senate Report No. 97-144, July 6, 1981, 2 U.S. Cong. and Admin. News, 97th Cong., 1st Session, page 245 et seq. 20

Treasury Decision 7468, 1984-2 C.B. 51 28

Webster's Third New International Dictionary (Unabridged) 46

Citation of Opinion Below

The opinion of the Court of Appeals for the Third Circuit in Lerman, et al., v. Commissioner, is reported at 939 F.2d 44 (1991). The Tax Court memorandum opinion in Fox, et al., v. Commissioner, T.C. Memo 1988-50, was not officially reported. Petitioner Fox withdrew from the case prior to the entry of the Tax Court's memorandum opinion. The Tax Court decision was affirmed sub nom Lerman, supra. The Tax Court memorandum opinion appears at 56 T.C.M. (CCH) 863(1988); and in 1988 PH TC Memo ¶ 88,570. The Lerman and Fox opinions appear in the Appendix.

Jurisdiction

The opinion of the Court of Appeals for the Third Circuit was filed on July 17, 1991. The judgment was entered on July 18, 1991. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1), and 26 U.S.C. § 7482(a)(1).

Statutes Invoked

Section 108 of the Tax Reform Act of 1984, as amended,[1] appears in the Appendix. The pertinent portions of Act Section 108 are:

> (a) GENERAL RULE. -- For purposes of the Internal Revenue Code of 1954,[2] in the case of any disposition of 1 or more positions
>
> (1) which are entered into before 1982 and form part of a straddle, and
>
> (2) to which the amendments made by title V of such Act [Economic Recovery Tax Act of 1981] do not apply, any loss from such disposition shall be allowed for the taxable year of the disposition if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into

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[1] Section 108 of Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630, as amended by section 1808(d) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2817 (hereinafter "Section 108").

[2] The transactions in issue are governed by the Internal Revenue Code of 1954, as amended. Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954, 26 U.S.C. Tax Title 26, as amended.

for profit though not connected with a trade or business.

(b) LOSS INCURRED IN A TRADE OR BUSINESS. -- For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.

The pertinent parts of Section 165 of the Internal Revenue Code of 1954, as amended, 26 U.S.C. § 165 are as follows:

Sec. 165. LOSSES

(a) GENERAL RULE. - There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * *

(c) LIMITATIONS ON LOSSES OF INDIVIDUALS. - In the case of an individual, the deduction under subsection (a) shall be limited to -

(1) Losses incurred in a trade or business;
(2) Losses incurred in any transaction entered into for profit, though not connected with a trade or business...

Statement of the Case

The taxpayer-appellants are commodities dealers. Principally during the years 1974 and 1975 they incurred losses in commodities straddle transactions. In the prototype commodities straddle the dealer enters into a long and a short position in the same commodity, which are regarded as offsetting or balanced positions. Whichever way the price of the underlying physical commodity moves, one position, or leg of the straddle, makes money, and the other yields a corresponding loss. The loss position is closed and the loss sustained is claimed on the tax return in the initial year of the transaction. A replacement position is acquired to retain the balanced nature of the offsetting positions. This closing of

the loss leg, and its replacement is called a "switch." The gain leg and replacement position are both closed in the subsequent year, in which taxpayer reports a gain corresponding to the loss taken in the prior year.

Commodities dealers have been permitted to utilize straddle transactions for decades. During the 1970's syndicators made the transactions available to large numbers of investors. In 1977, the Internal Revenue Service challenged the transactions under a variety of theories. Revenue Ruling 77-185, 1977-1 C.B. 48 (1977).

Pursuant to the positions taken in the Revenue Ruling, the Internal Revenue Service disallowed the losses reported by the petitioners herein. At the conclusion of the administrative audit,

beginning in 1979, each petitioned the Tax Court for a redetermination of the deficiencies proposed against him by the Commissioner of Internal Revenue.

As part of the Economic Recovery Tax Act of 1981 (ERTA), P.L. 97-34, Congress enacted definitive prospective rules for the treatment of commodities and other straddle transactions. This legislation foreclosed the type of straddle transaction here in issue: the reporting of losses in a taxable period prior to the reporting of the corresponding gain. Except with respect to dealers engaged in hedging transactions, the legislation foreclosed the future use of what were known as "commodities tax straddles."

During the years that the petitioners' consolidated case was pending in the Tax Court thousands of

additional petitions were filed by other taxpayers contesting the disallowances of losses claimed in straddle transactions. In addition, many thousands of cases were under consideration by the Internal Revenue Service. The vast majority of the cases and audits involved non-dealer investors. These pending and potential cases threatened to overwhelm the Tax Court. As a direct result, Congress passed Section 108 of the Tax Reform Act of 1984 with the express purpose of providing definitive rules for disputed pre-1981 transactions to clear the Tax Court's docket. Following Section 108's misinterpretation by the Tax Court, Section 108 was amended by the Tax Reform Act of 1986 to provide a per se rule of allowance of losses for dealer transactions. Non-dealer investors were

required to establish that their commodities tax straddles were entered into primarily for profit.

The issue presented to the Tax Court on motion for summary judgment was whether the losses petitioners sustained in closing the loss legs or positions of various commodities straddles were entitled to recognition. The Tax Court decided the issue in favor of the Commissioner. The Court of Appeals for the Third Circuit affirmed the decision of the Tax Court. Both the Tax Court and Court of Appeals rendered Congress' attempt at providing objective rules of allowance for dealers' pre-1981 transactions nugatory, by testing the validity of the transactions under judicial concepts created for interpretation of the Internal Revenue

Code. These concepts are inapplicable to this special legislation of retroactive effect, not codified as part of the Internal Revenue Code. The purpose of the legislation was to settle a large number of cases, in which the validity of the underlying transactions would otherwise remain in issue under the Code, without requiring judicial intervention to examine each case on the merits. The decision below frustrates that purpose and subverts the invent of the Congress.

Reasons for Granting the Writ

This case is part of the continuing saga of the Courts' uncritical support of an Internal Revenue Service's institutional aversion to so-called commodity tax straddle transactions. The Court of Appeals for the Third Circuit and the Tax Court have so far departed from the accepted and usual course of judicial proceedings as to call for an exercise of the Courts' power of supervision.

The taxpayers sustained losses in silver straddles in which they engaged, principally in the years 1975 and 1976. The Commissioner of Internal Revenue ("Commissioner") disallowed the losses which the taxpayers claimed and his determination has been upheld by the Court of Appeals for the Third Circuit,

notwithstanding Section 108 (Appendix A-74).

The Tax Court held that the statutory conclusive presumption that the losses they sustained were incurred in their trade or business as commodities dealers--as they are by stipulation for purposes of this appeal--was not available to them because their straddle losses were "prearranged" in the sense that the losses which they sustained were always sustained in the first year of the straddles while the straddles produced no significant economic gains, i.e. straddle gains minus straddle losses minus commissions. The issues which are raised on this appeal are therefore whether the Congress, in Section 108, intended to grant recognition to commodities dealers taxpayers in straddle transactions of the

kind in which petitioners engaged and whether the use of the word "prearranged" which appears but once in the language of the Report of the House Conference Committee supports the Tax Court's determination that Section 108 does not mean what it appears to say.

Other courts have upheld the Commissioner's decision, citing Gregory v. Helvering, 293 U.S. 465 (1935), in support of their conclusion; but whether the loss deductions are denied by whichever label--want of economic substance, absence of business purpose, legal sham--the question is the same. What did the Congress intend?

Obviously, it fell within the province of Congress to enact a statute to provide to commodities dealers tax losses which in other circumstances, at

other times, would be unavailable to them. If the Court finds that it was the Congress's intent to permit dealers to deduct losses sustained in commodities straddle transactions, it is not for the courts to inquire whether under different circumstances, or in other cases, the loss would not have been allowed.

The position was well stated in Gideron, "Mrs. Gregory's Grandchildren: Judicial Restrictions of Tax Shelters," 5 Va Tax Rev. 825 (1988). The author, K.W. Gideon, formerly Chief Counsel for the Internal Revenue Service (1981-1983), put it well:

> ...The Gregory Court rested its decision on a determination that Mrs. Gregory's reorganization was outside the intent of Congress in enacting the reorganization provision. This test ought to be the first inquiry in any tax-shelter case, <u>for if a court concludes that Congress intends the result sought by a taxpayer, that ends the matter,</u>

without regard to whether a judicial test has been offended. ...

...Where no congressional intention to grant benefits can be discerned, courts generally deny effect to transactions that have no purpose other than tax avoidance. Judge Learned Hand explained the rationale for denying unintended benefits as follows:

> If, however, the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose of that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose.*

It is worth restating, however, that the test is in two parts: only if a court concludes that the result was unintended by Congress need it inquire whether there was a purpose other than tax avoidance. ... Gideon, 5 Va. Tax. Rev. 825, 827, 28 [Underscoring added]

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* Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957) (dissenting opinion).

Even prior to discussing what Congress intended to do and what Congress understood it was doing in enacting § 108, it should be emphasized that § 108 is no rule of prospective application. On the contrary, the legislation is retroactive and applies only to transactions long since concluded and incapable of repetition. Thus, arguments which have been advanced which suggest that the construction of § 108 for which the taxpayers here contend would militate against or sap the vitality of the business purpose doctrine or the economic substance requirement are invalid. Section 108 offers no "safe harbor" for any transaction engaged in after its enactment. No person engaged in a commodity straddle in anticipation of its enactment. It was designed solely to

accomplish the purpose of clearing the Tax Court Docket of the thousands of tax shelter cases which were threatening to put the Tax Court out of business and to help commodities dealers.

> ...Further, the conferences clarify their intent that the Internal Revenue Service bring all outstanding pre-ERTA straddle litigation to a speedy resolution so that the large docket of cases on this issue may be cleared in a manner consistent with this legislation. (Conference Committee Report on Publ. L. No. 99-514, Section 1808 (d), 100 Stat. 2085, 2817 (1986)).

Appellants submit that in enacting § 108 in 1084, and amending it to its present form in 1986, the Congress knew what it was doing, intended to do what it did, and understood what the cost to the revenue of its action would entail.

As far back as 1981, when the Congress was considering the Economic

Recovery Tax Act of 1981 ("ERTA"), Senator Moynihan, who introduced the bill, placed in the record the Treasury Proposal for Tax Treatment of Commodities Straddles and Related Transactions (Cong. Rec. Vol. 126, Part 3, pp. 3674-3676). In its proposal, the Treasury described at length the various straddle techniques which were utilized to defer the reporting of income and the conversion of short-term gains (then taxed at a maximum of 70%) to long-term capital gains (then taxed at a maximum of 28% rate). The Treasury proposals described the tax deferrals of straddles in detail and described them a "unconscionable". ERTA was enacted to prevent the utilization of straddles for tax deferral by requiring the taxpayers at the close of the year to mark their straddle positions to the

market. Thus, at the close of the year the loss sustained or inherent in one leg of the straddle would be offset by the inherent gain in the other leg and the taxpayer would have no net loss to claim. Senator Moynihan, who introduced the bill, while declining to estimate the total cost to the economy, stated that unless checked the Government would lose $1,300,000,000 from straddles in 1982 and even greater amounts in 1983 and subsequent years. 127 Cong. Rec. Part B, p. 3673 (March 5, 1981).

The ERTA straddle provisions derived from the Senate bill. In Conference, the House deferred to the Senate. The Senate report on the bill (Senate Report No. 97-144, July 6, 1981, 2 U.S. Cong. and Admin. News, 97th Cong., 1st Session, page 245 et seq.) demonstrates the

awareness which Congress had of the commodities tax straddle.

Particularly noteworthy is the description of the type of tax straddle which the Internal Revenue Service was said to be litigating. While one straddle may differ from another in details or in sophistication, the straddle which was described epitomizes all tax straddles and was a part of the background of Congress' knowledge in enacting Section 108.

> In the transaction described in the Revenue Rule [i.e., Rev. Rul. 77-185, 1977-1 C.B. 48] the taxpayers, on August 1, 1975, simultaneously sold silver futures contracts for July delivery and purchased an identical number of silver futures contracts for March delivery. Three days later, the March contracts were sold for a loss and an identical number of May contracts were purchased. On February 18 of the following year, the taxpayer simultaneously sold

> the May contracts and purchased July contracts to cover the short position. The taxpayer reported a loss from the sale of the March silver contracts in 1975 which reduced its short-term gain from the sale of real estate and reported a net long-term gain in the next year from the sale of the futures contracts.

By 1984, when § 108 was first enacted, at least 4,400 straddle cases were pending before the Tax Court. Miller v. Commissioner, 84 T.C. 827, 855 (1983). There were originally over 1,400 petitioners in the Glass case (Glass v. Commissioner, 87 T. C. 1087 (1986) alone. Again, the Congress was informed of the loss of revenue which was being suffered as a result of tax straddles but, more significantly, the Congress knew the benefit which § 108 was intended to confer upon commodity dealers. Senator Metzenbaum, speaking ont he floor of the

Senate on June 27, 1984, made it clear to his colleagues that § 108 was designed to benefit the commodity traders and dealers. He stated (Cong. Rec. S. 8390 (Daily Edition, June 27, 1984)):

> But as the conferees were eliminating some of the revenue losers, two special-interest groups were hard at work, the Chicago Board of Trade and the Chicago Mercantile Exchange, two of the Nation's largest commodity futures trading organizations, did not want to stand in line outside the Finance Committee hearing room. They did not bother to find a Senator to offer their amendment on the floor where it could be examined and debated. Perhaps they thought someone might challenge the $300 million giveaway. Perhaps they feared that the press would publish an embarrassing article, or perhaps they simply saw a little too late that everyone else was getting their share and they felt left out.
>
> Whatever the circumstances, these two interest groups were able to have their amendment adopted in conference and the effect of that provi-

sion is virtually to preclude the IRS from pursuing tax cases against about 200 traders of commodity futures for an estimated $300 million in taxes that the IRS is trying to collect from traders who used the now out-lawed tax avoidance scheme known as a commodity straddle.

As a matter of fact, the IRS preliminary data indicates that there are 4,400 cases presently pending in Tax Court representing $500 million in taxes before interest is assessed. The IRS has assessed deficiencies for 15,000 taxpayers for $1.5 billion. There is no data on how many professional traders are involved, but we do know that whether it is $300 million or $500 million or a substantial amount more, the commodity traders and dealers were well taken care of in the conference committee on a matter was not at issue between the House and the Senate. The conference committee reached out, brought in this entirely new matter, which cost the rest of the taxpayers in this country anywhere from 300 million to 500 million or more dollars. And what happened? The conference committee brings it

> back to us and we have no choice but to accept it.

Representative Richard L. Ottinger, by remarks extended in the Congressional Record of July 24, 1984 (12 Cong. Rec. E. 3251), recommended to his colleagues an article in the Washington Post which directed attention to the benefits which § 108 was intended to provide to the dealer favorites of the Chairman of the House Ways and Means Committee. While many of his fellow Representatives may not have read Congressman Ottinger's remarks, it is undoubtedly a fact that many of them are readers of the Washington Post, where the article appeared, and would have read it there (see Appendix A-77).

Dissenting in Miller v. Commissioner, 84 T.C. 827 (1985),[3] which held that Section 108 established a different, less rigorous "profit" test than that of Section 165(c)(2), Judge Simpson of the Tax Court referred to Senator Metzenbaum's and Congressman Ottinger's statements:

> These statements by Senator Metzenbaum and Representative Ottinger do reflect the contemporaneous understanding of what Congress was doing by the enactment of section 108. Congress realized that it was extending substantial tax relief to dealers in tax straddles, but these statements make it indisputably clear that Congress had no understanding that it was granting tax relief to all traders in tax straddles with a consequent loss in revenue exceeding $1.5 billion. The outcry by the critics of the legislation would, no doubt, have been substantially greater had they understood that the legislation was

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[3] The Tax Court was reversed by the 10th Circuit in 836 Fed. 2d 1274 (1988).

> extending tax relief to all traders of tax straddles.

Chief Judge Dawson also dissented, saying (p. 857):

> However, I firmly believe that Congress did not intend for section 108 to encompass all pre-ERTA commodity straddles. I am unwilling to attribute such an intend to the conferees of the tax-writing committees and to the members of Congress. The conclusion of the majority here represents a sharp departure from the principle of judicial restraint by relying on murky and gratuitous legislative history which flies in the face of the plain language of the statute. I think we should stay our hand and apply section 108 only to its intended recipients--commodity dealers.

Only by closing one's eyes to reality may it be said that the Congress in enacting Section 108 had in contemplation some sort of straddle transaction of a different kind than that in which the taxpayers here engaged. The

prototypical straddle had been exposed to the members of Congress in the Treasury's recommendations in 1981. The Conference Committee, in enacting Section 108 in 1984, considered and referred to Revenue Ruling 77-185, 1977-1 C.B. 48 (1977), in which the Commissioner described the tax straddle technique and gave as an example the silver straddle which the Senate report on ERTA described. While the Conference Committee made it clear in subsection (a) that Section 108 applied to the disposition of a single position forming part of a straddle, causing the Internal Revenue Service formally to abandon the "complete transaction" argument advanced in the Ruling, the fact of the taxpayer's disposition of the loss leg of the straddle in year one of the transactions remained the cornerstone of

its position that the transactions were "prearranged" and therefore outside the scope of Section 108.

The enactment of Section 108 was followed by the Commissioner's Temporary Regulations (Treasury Decision 7468, 1984-2 C.B. 51), in which in a variety of ways he sought to limit the damage which Section 108 had inflicted upon his litigating position. So far as this appeal is concerned, it should be noted that the Commissioner's regulations imposed a "primary purpose of realizing an economic profit" test on dealers as well as upon investors, required consideration of the "nature and extent" of the dealer's trading activities, and limited the availability of the profit presumption to transactions in the

commodities in which the dealer normally traded.[4]

The Congress reacted in 1986 with the amendment of Section 108. The imposition of the "primary purpose of realizing an economic profit test" was made specifically applicable to investors (by use of the specific language of Section 165(c)(2) in the enactment and by saying so in the conference report) to reject the Tax Court's Miller decision but not to commodities dealers. For them, Congress authorized the decision of commodity straddler losses "if incurred in a trade or business" and created a conclusive presumption that "any loss incurred by a commodities dealer in the trading of commodities shall be treated

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[4] Certain of the Commissioner's glosses on Section 108 were struck down by the Court of Appeals in its reversal of the Tax Court's decision in Miller. 836 F.2d 1274.

as a loss incurred in a trade or business.[5] With its demonstrated awareness of the state of the law, the Conference Committee, had it wished to impose the Section 165(c)(2) test upon dealers, would undoubtedly have had the acumen to accomplish that result. Instead, it established a new conclusive presumption that a dealer's straddle transaction losses were incurred in a trade or business [subsection (b)] and made such losses deductible by the dealer sustaining them [subsection (a)]. Their clear intent to treat dealers as a favored class and to make the "profit

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[5] The 1986 Act added additional "goodies" for commodities dealers. It expanded the scope of the definition of a "Commodities Dealer" in subsection (f) of the amended section to include members of the dealer's family in certain circumstances and clarified a latent ambiguity of subsection (h) to make it clear that the inapplicability of Section 108 to syndicates did not operate to deprive a dealer member of the syndicate of its benefits.

motive" test inapplicable to them is clearly evidenced by this history of Section 108.

The Conference Committee, expanding on what the House Committee had said,[6] then systematically dismantled all of the other roadblocks which the Commissioner in his Temporary Regulations had sought to erect to make Section 108 of only illusory benefit to commodities dealers. Adopting and expanding upon the House position, the Conference Committee stated:

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[6] "If a person qualifies as a commodities dealer, the subsection (b) treatment applies with respect to any position disposed of by such person. It would, for example, apply without regard to whether the position was in a commodity regularly traded by the person, whether it was traded on an exchange on which the dealer was a member, or whether an identical position was re-established on the same trading day or subsequently."

House Report No. 99-426 at 911, 1986-3 C.B. (Vol. 2) 911.

> If a person qualifies as a commodities dealer, the subsection (b) treatment applies with respect to any position disposed of by such person. It would, for example, apply without regard to whether the position was in a commodity regularly traded by the person, whether it was traded on an exchange on which the dealer was a member, or whether an identical position was re-established on the same trading day or subsequently. The conferees also wish to clarify that if an individual owns a seat on a commodities exchange, such individual will be treated as a "commodities dealer." (Emphasis added). Conference Report No. 99-841, PII-845, 5 U.S.CC&A News, (1986) p. 4933.

Of particular significance (and inexplicably overlooked by the Tax Court) is the clear statement that the Section 108 trade or business presumption, "the subsection (b) treatment," applies "whether an identical position was re-established on the same trading day or subsequently.

To accomplish a commodity tax straddle, a commodity dealer must sustain a loss in year one through the closing of the loss position, reinstate the loss position immediately so as to maintain a balanced position (a "switch"), thereby to avoid the risk of loss consequent upon the maintenance of an unbalanced or "naked" position, and then close the gain (and replacement) leg in year two. The closing and replacement of the loss leg of the straddle--the "switch"--is critical to its success and distinguishes it from a straddle which has a profit or business purpose motivation. The Court of Appeals, in Miller, recognized the distinction, saying (p. 1926):

> Acquiring a commodity straddle carries with it less risk than acquiring an open position because the spread will be less volatile than the price of either leg.

Consequently, the expected return is less than that of an open position, that margin requirements for a straddle are somewhat lower than those for open positions. Before June, 1981, commodity straddles were perceived as a tax planning device enabling a taxpayer to defer tax liability on an unrelated capital gain until a later year and to convert short-term capital gain into long-term capital gain. With this strategy, a taxpayer would close out the loss leg of the straddle in Year 1 so as to realize a tax loss. Simultaneously, and while retaining the gain leg, the taxpayer would acquire an offsetting position to replace the closed loss leg. The new position would be similar to the closed leg, but with delivery in a different month. This substitution of one position for a similar position in a different month is known a "switch." The spread, created by the switch coupled with the retained gain position, would maintain the taxpayer's "hedged" position, which would be held into Year 2. A typical straddle traded for tax purposes will include a switch (and thus is distinguishable), while a typical straddle traded for nontax purposes will not

> include a switch. Optimally, this hedged profit position would be held for more than six months and closed out in Year 2 so as to realize long-term capital gain.
> [footnotes omitted]

Thus, what the Conference Committee, following the House, was saying was that if a commodities dealer had engaged in just such transactions the loss he sustained in year one would be allowable as a "loss incurred in a trade or business" by virtue of the subsection (b) presumption. In that single sentence of the House and Committee reports, the Committees gave their imprimatur to the commodity tax straddles in which their favored constituents had engaged.[7] To

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[7] We re-emphasize that no rule to govern future or unaccomplished transactions was being announced: that only a piece of special legislation of retroactive application is involved. After the last cases under Section 108 have been decided, Section 108 will be as vestigial to the Code as the appendix is to the human body.

suggest otherwise in the light of what the statute provides and what the Committee said is either to intimate that the members of the Conference Committee (Congressman Rostenkowski, Chairman of the House Ways and Means Committee, and Senator Dole, Chairman of the Senate Finance Committee, among others) either did not know what the words they used meant or used them in some Aesopian mode to convey different meanings than the words would normally connote so that their constituents would believe that something had been accomplished for their benefit while, in fact, such would not be the case. If such were the case, not only Chairman Rostenkowski's constituents have been misled, so too have learned commentators who have stated that Section 108, as amended, "gave amnesty to

everyone engaged in the commodities trading business...[8]

How, then, to explain the Court's refusal to recognize and respect the obvious? Only that it ran against the grain of the Court's ideology to accept Congress' command that in the case of commodities straddles of commodity dealers the Court was to forego its

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[8] Re-examining the Nature and Role of Tax Legislative History in light of the Changing Realities of the Process, by Lubick, Hickman and Ferguson, a paper delivered at the Forty-Second Annual Federal Tax Conference of the University of Chicago Law School, reprinted in Taxes, the Tax Magazine, Dec. 1989, Vol. 67, No. 12, P. 814, Fn. 19.

Donald C. Lubick who was Tax Legislative Counsel of the Treasury Department during the Kennedy-Johnson Administrations, 1961-1964, and returned as Deputy Assistant Secretary and then Assistant Secretary of the Treasury for Tax Policy during the Carter administration, 1977-1981. Frederick W. Hickman who was Assistant Secretary of the Treasury for Tax Policy during the Nixon-Ford administrations, 1972-1975. Bradford L. Ferguson who was Tax Legislative Assistant to Senator Walter Mondale, then a member of the Senate Finance Committee, 1975-1977. During the Carter administration, he was Special Assistant to the Assistant Secretary of the Treasury for Tax Policy, 1977-1979, and Associate Tax Legislative Counsel of the Treasury Department, 1979-1980.

customary inquiry into business purpose and obey Congress' dictate of deductibility. Disciplined as it was by fifty-five years of adherence to Gregory v. Helvering, 293 U.S. 463 (1935), the Tax Court found itself unable to bend to the will of Congress. Only such inflexibility can explain a statement such as that of the Chief Judge of the Tax Court in Cook v. Commissioner, 90 T.C. 975 (1988), a commodity dealer commodities straddle case, that "we think it would be highly anomalous to disallow loss deductions to over 1,000 petitioners claiming them under the London options transaction, as we have done in Glass, while allowing them to petitioner, even though a dealer, on the self-same transaction." What Judge Nims and his concurring judges refused to note--or

could not force themselves to accept--was that congress had mandated a different norm whereby to measure the consequences of dealer transactions than the yardstick which it said was to be applied to non-dealer taxpayers.

In order to deny deductibility to losses which the statute stated were deductible, the Court fashioned an end run around Section 108. Seizing on the word "prearranged" in the House Report[9], the Court concluded, as the Tax Court had in Cook, that the straddle losses were pre-arranged and therefore produced no losses to which the Section 108 dealer presumption would apply.

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[9] "Further, the presumption (of Section 108(b)) would not be available in any cases where the trades were fictitious, prearranged or otherwise in violation of the rules of the exchange..."

The sentence does not appear in the Conference Committee Report.

We submit that the Court gave an insupportable definition to the word "prearranged." Analysis of the Conference Committee Report will make this clear.

Taking the Report as a whole, the meaning and effect to be given to any of its provisions must be consistent with its clearly expressed purpose. Here, the Conference Committee, in 1984 and 1986, expressed explicitly its purpose "to bring all outstanding pre-ERTA straddle litigation to a speedy resolution, so that the large docket of cases in this issue may be cleared in a manner consistent with this legislation." The meaning to be ascribed to the word "prearranged" must therefore serve this expressed intent. We submit that the meaning given by the Tax Court to the

word "prearranged" subverts the intent of the Conference Committee rather than effectuating it. All that the Tax Court has done by its definition is to create a new legal thicket--Did the transactions have substantial economic effect?--in place of the former area of disputation--were the transactions entered into principally for profit?

If one examines the amended Section 108 and the Conference Committee Report, it will readily be seen how the Congress sought to achieve its purpose. It first encouraged the investor litigants to settle their cases or concede defeat by imposing upon them the well-nigh insuperable burden of establishing that their transactions were primarily for profit; and it sought to encourage the Service to settle or concede the balance

of the cases, those of the dealers, by its conclusive trade or business presumption, perhaps permitting a few undeserving petitioners to escape as the price of ridding the Tax Court's docket of the dealer cases which involved the "highly complex business of trading on commodity exchanges."[10] But while granting amnesty to dealers, the amnesty was to be limited to the factual, real trades, thus putting beyond the pale those who engaged in fictitious or prearranged trades or trades in violation of rules designed to insure the integrity of the market place.

Further, the Court's interpretation of the word "prearranged' rejects the rule of noscitur a sociis, a rule

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[10] Lubick, Hickman and Ferfuson, supra, note 7.

endorsed by this Court in Jarecki v. G.D. Searle & Co., 367 U.S. 303 (1961).

There, the issue was whether Searle, which had conducted research for more than 12 months, and produced new drugs for which it received patents, or Polaroid, which over a lengthier period had produced the Polaroid camera for which it received numerous patents, were entitled to relief from excess profits tax under Section 456(a)(2)(B) of the Internal Revenue Code, which defined "abnormal income" as:

> ...Income resulting from exploration, discovery, or prospecting, or any combination of the foregoing, extending over a period of more than 12 months. ...

on the theory that the income derived from their respective products was "abnormal income" from "discovery." In language which is meaningful as a guide

to the construction to be given in this case to the word "prearranged," the Court rejected the claims, saying (p. 307):

> We look first to the fact of the statute. "Discovery" is a word usable in many contexts and with various shades of meaning. Here, however, it does not stand alone, but gathers meaning from the words around it. These words strongly suggest that a precise and narrow application was intended in §456. The three words in conjunction, "exploration," discovery" and "prospecting" all describe income-producing activity in the oil and gas and mining industries, but it is difficult to conceive of any other industry to which they all apply. Certainly the development and manufacture of drugs and cameras are not such industries. The maxim noscitur a sociis, that a word is known by the company it keeps, while not an inescapable rule, is often wisely applied where a word is capable of many meanings in order to avoid the giving of unintended breadth to the Acts of Congress. See, e.g., Neal v. Clar, 95 U.S. 704, 709-709. The application of the maxim here leads to the

conclusion that "discovery" in § 456 means only the discovery of mineral resources.

Appellants believe that, consistent with the rule, prearranged trades as used in the sentence means trades prearranged in the transactional sense, i.e., in the manner of their accomplishment: e.g. trades arranged between buyer and seller off the floor of the exchange and nominally executed on the floor, trades between brokers in the nature of wash sales, "cross trades."[11] in which, by agreement, no broker intervenes to prevent the completion of the cross, or the like; that is, prearranged in the context of the sentence means "fake" or

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[11] A simultaneous purchase and sale at the market price for different principals for a like quantity of a commodity for future delivery in the same month conducted on the floor of the exchange at public outcry across the rign. See 7 U.S.C. §6b. See e.g. Miller v. Commissioner, 836 F.2d 1274, at 1287.

"phoney" trades or trades violative of the rules of the exchange upon which they were conducted. Logically, this must be so, for the phrase in which "prearranged" appears concludes with the words "or otherwise in violation of the rules of the exchange..."

"Otherwise" means in a different way or manner[12] from that which went before. "Otherwise in violation of the rules of the exchange" is therefore a catch-all designed to embrace all forms of conduct violative of exchange rules which were not comprehended within the words "fictitious" or "prearranged." Thus, the word "prearranged" could not have the meaning that the Tax Court ascribes to it. According to the Tax Court, trades are prearranged, albeit they are real, if

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[12] Webster's Third New International Dictionary (Unabridged).

they are wanting in economic substance--are not engaged in for profit. But no "prearranged sequence of trading calculated to achieve a tax-avoidance objective" violates any exchange rule if the component trades are real--not fictitious--and not prearranged in the manner of their execution. The ultimate objective of a taxpayer to minimize his tax liability through a series of real trades on the exchange is a matter of utter indifference to the exchange. What matters only to the exchange is that the trades be not fictitious, not prearranged in the transactional sense, and "not <u>otherwise</u>" in violation of its rules: that the trades not impair the integrity of the market. Validity can be given to the Tax Court' use of "prearranged" only

by deliberately closing one's eyes to the existence of the word "otherwise."

What the House Committee undoubtedly had in mind were the prohibitions against fictitious sales contained in the Commodity Exchange Act, 7 U.S.C. Section 6c(a)(A), and Regulation Section 1155.2(f) of the Commodity Futures Trading Commission, 17 C.F.R. Section 155.2(f), CCH Commodity Futures Law Reporter, Par. 3182, which requires each contract market (i.e. Exchange) to adopt, as one of the rules establishing standards for floor brokers, a rule to "Prohibit such member from making any purchase or sale which has been directly or indirectly prearranged."

Clearly, the House Committee was saying only that dealer transactions which violated rules regulating broker

conduct (such as rules prohibiting fictitious or prearranged trades--rules which, with the Exchange's other rules, are designed to preserve the integrity of the marketplace) would not be protected by Section 108. What the House Committee was saying in an admittedly imperfect manner was that if a dealer engaged in trades which did not violate the rules of the marketplace, his losses from such trades were to be allowed to him as a trade or business loss.

The conclusion we have reached is supported by Judge Whitaker's concurring opinion in Cook, supra. He said (p. 990):

> The majority also attempts to find support for the conclusion that section 108 does not apply in the legislative history by relying on the word "prearranged." Again I disagree with the majority's analysis. I am constrained to

conclude that the Ways and Means Committee used the word "prearranged" as equivalent to "fictitious" and as a way of describing that species of transactions which we treat as factual shams as in Brown v. Commissioner, 85 T.C. 968 (1985), affd. sub. nom. Sochin v. Commissioner, 843 F.2d 351 9th Cir. 1988), and Julien v. Commissioner, 85 T.C. 492 (1984). In my judgment, there is no basis for expanding the exclusion from the scope of section 108 beyond that specified in the House Ways and Means Committee report, which should constitute the maximum reach of our legislative interpretation.

This and the Glass opinion are the first occasions in which this court has used "prearranged" to mean other than "false" or "fictitious."[4] ...

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4 So far as I have been able to determine this Court has consistently used "prearranged" to mean "rigged", "fixed", "artificial", i.e., a "factual sham." The "manipulation" that occurred in DeMartino v. Commissioner, T.C. Memo, 1986-263, was price manipulation in

trades that violated the rules of the exchange. Unless this Court is prepared to disregard all transactions on the London Metal Exchange, the kind of factual findings made in DeMartino are required here. All the other cases cited by my colleague likewise presented false or fictitious transactions--so-called factual shams--found by this Court to be shams only after the Court had found the necessary facts to support the conclusion that the transactions were not bona fide, Forseth v. Commissioner, 85 T.C. 127, 149 (1985), affd. 818 F.2d 293 (9th Cir. 1987). We stated this principle in a recent Court-reviewed opinion, Perlin v. Commissioner, 86 T.C. 388, 415 (1966) as follows:

"Alleged transactions involving commodity futures contracts which are in fact prearranged or fictitious will not be recognized for Federal tax purposes. See Brown v. Commissioner, 85 T.C. 968 (1985); Forseth v. Commissioner, 85 T.C. 127 (1985); Miller v. Commissioner, 84 T.C. 827 (1985), on appeal (10th Cir., Nov. 20, 1985); Julien v. Commissioner, 82 T.C. 492 (1984).***"

The ultimate authority cited by the Court below to support its decision is the DeMartino case, supra. There, a dealer case, the Court of Appeals for the Second Circuit, in an expansive dictum, appeared to support the Service's position that a pre-condition to the applicability of Section 108, as amended, is a finding that the dealer trading in question have economic substance. However, that statement must be taken in context for the Court had already (p. 406) upheld the Tax Court's findings of fact, that DeMartino's trades were not bona fide, saying:

> ...that the taxpayer had failed to meet this burden [of establishing that the purported trades were bona fide] and that the commodity straddles were prearranged, contrived transactions conducted in a

market rigged to produce tax losses."[13]

Consequently, in the context of the factual setting of DeMartino, the statement must be read only in the sense of permitting inquiry into the bona fides of the underlying transactions, for the Court agreed that "Congress eliminated the profit motive inquiry in cases involving dealers...". Thus, it may be concluded that if the transactions in issue in DeMartino had been bona fide and not factual shams--not fictitious,

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[13] The Tax court had found (DeMartino v. Commissioner of Internal Revenue, 51 TCM 1278, 1284) that the trades were prearranged outside the trading ring in contravention of regulations of the Commodity Futures Trading Commission by Hamilton, the broker who executed them, and Norman Turkish. Turkish was convicted of conspiring to defraud the United States (48 U.S.C. § 371), United States v. Turkish, 623 F.2d 769 (2nd Cir. 1980) as a result of being involved in a conspiracy to fix, rig and prearrange commodity futures transactions in the Crude Oil Market. The other participant, Alfred Perlmutter, pled guilty to fixing, rigging and prearranging trades and manipulating the prices of the Crude Oil Market.

prearranged, or otherwise in violation of the rules of the exchange--the Court would have found that Section 108, as amended, permits the deduction of dealer straddle losses. "Section 108(a) does not apply to straddle transactions that are shams," it was held, but its intent to refer to factual shams only is clear from its citation in support of its proposition of factual sham cases only.[14]

The expressed desire of the Congress in enacting Section 108 was to bring the mass of straddle cases to a close. Given the construction placed upon Section 108 by the Court below, none of the cases of the several hundred dealers noted by Senator Metzenbaum will be affected. How

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[14] Sochin v. Commissioner, 843 F.2d 351 (8th Cir. 1988; Enrici v. Commissioner, 813 F.2d 293 (9th Cir. 1987); Mahoney v. Commissioner, 808 F.2d 1219 (6th Cir. 1987); and Forseth v. Commissioner, 845 F.2d 746 (7th Cir. 1988).

pleased he will be to learn that his fears were unfounded--tempered perhaps by his surprise at learning that he didn't know how to read plain English!

CONCLUSION

For the foregoing reasons, in order to prevent a complete usurpation of the Congresses' authority to conclude pending controversies, this Court should issue a Writ of Certiorari to the United States Court of Appeals for the Third Circuit with respect to this case.

Respectflly submitted,

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October 15, 1991

SECTION 108

Section 108 of Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630, as amended by section 1808(d) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2817.

SEC. 108. TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.

(a) GENERAL RULE. — For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions —

(1) which are entered into before 1982 and form part of a straddle, and

(2) to which the amendments made by title V of such Act [Economic Recovery Tax Act of 1981] do not apply, any loss from such disposition shall be allowed for the taxable year of the disposition if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business.

(b) LOSS INCURRED IN A TRADE OR BUSINESS. — For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.

(c) NET LOSS ALLOWED. — If any loss with respect to a position described in paragraphs (1) and (2) of subsection (a) is not allowable as a deduction (after applying subsections (a) and (b)), such loss shall be allowed in determining the gain or loss from dispositions of other positions in the straddle to the extent required to accurately reflect the taxpayer's net gain or loss from all positions in such straddle.

(d) OTHER RULES. – Except as otherwise provided in subsections (a) and (c) and in sections 1233 and 1234 of such Code, the determination of whether there is recognized gain or loss with respect to a position, and the amount and timing of such gain or loss, and the treatment of such gain or loss as long-term or short-term shall be made without regard to whether such position constitutes part of a straddle.

(e) STRADDLE. – For purposes of this section, the term "straddle" has the meaning given to such term by section 1092(c) of the Internal Revenue Code of 1954 as in effect on the day after the date of the enactment of the Economic Recovery Tax Act of 1981, and shall include a straddle all the positions of which are regulated futures contracts.

(f) COMMODITIES DEALERS. – For purposes of this section, the term "commodities dealer" means any taxpayer who –

(1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B) of the Internal Revenue Code of 1954 (as added by this subtitle), or

(2) was a member of the family (within the meaning of section 704(e)(3) of such Code) of an individual described in paragraph (1) to the extent such member engaged in commodities trading through an organization the members of which consisted solely of –

(A) 1 or more individuals described in paragraph (1), and

(B) 1 or more members of the families (as so defined) of such individuals.

(g) REGULATED FUTURES CONTRACTS. – For purposes of this section, the term "regulated futures contracts" has the meaning given to such term by section 1256(b) of the Internal Revenue Code of 1954 (as in effect before the date of enactment of this Act).

(h) SYNDICATES. — For purposes of this section, any loss incurred by a person (other than a commodities dealer) with respect to an interest in a syndicate (within the meaning of section 1256(e)(3)(B) of the Internal Revenue Code of 1954) shall not be considered to be a loss incurred in a trade or business.

APPENDIX

TABLE OF CONTENTS

	Page
Opinion of the United States Court of Appeals for the Third Circuit, Filed July 17, 1991	A-1
Judgment of the United States Court of Appeals for the Third Circuit, Dated July 18, 1991	A-35
Tax Court Memorandum Opinion in *Fox v. Commissioner of Internal Revenue*	A-38
Decision of the United States Tax Court in *Lerman v. Commissioner of Internal Revenue*	A-55
Decision of the United States Tax Court in *Fraites v. Commissioner of Internal Revenue*	A-56
Decision of the United States Tax Court in *Massey v. Commissioner of Internal Revenue*	A-57
Stipulation of Facts	A-58
Section 108 of The Tax Reform Act of 1984, as Amended	A-74
"Remarks of Sen. Ottinger" Cong. Rec. - Extension of Remarks July 24, 1984, p. E 3251	A-77

Filed July 17, 1991

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 90-1813, 90-1814, 90-1815,
90-1835, 90-1836, 90-1837

CHARLES S. LERMAN and BARBARA LERMAN,

Cross-Appellants at No. 90-1835
Appellees at No. 90-1813

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant at No. 90-1813
Cross-Appellee at No. 90-1835

JOSEPH L. FRAITES and EVELYN FRAITES,

Cross-Appellants at No. 90-1836
Appellees at No. 90-1814

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant at No. 90-1814
Cross-Appellee at No. 90-1836

DWIGHT B. MASSEY and JOANN V. MASSEY,
Cross-Appellants at No. 90-1837
Appellees at No. 90-1815

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellant at No. 90-1815
Cross-Appellee at No. 90-1837

On Appeal from the United States Tax Court
T.C. Nos. 79-10239, 80-22295, 81-23614

Argued June 6, 1991

BEFORE: SLOVITER, *Chief Judge*, and
GREENBERG and HIGGINBOTHAM,
Circuit Judges

(Filed: July 17, 1991)

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OPINION OF THE COURT

GREENBERG, *Circuit Judge.*

Introduction

This case involves the continuing saga of a crackdown by the Commissioner of Internal Revenue on a tax shelter device we will call the "option-straddle transaction" and the divers attempts of various taxpayers to avoid the consequences of this crackdown.

The particular straddle transactions involved silver options on the London Metals Exchange. Appellant-taxpayers, Charles S. Lerman, Joseph L. Faites, and Dwight B. Massey, who on this appeal are assumed to be commodities dealers, engaged in the transactions on the Exchange, and deducted losses, for 1975, 1976, and 1977 purportedly incurred in those transactions. The Commissioner disallowed the deductions and assessed deficiencies against them. The appellants sought a redetermination of the deficiencies in the Tax Court, and both sides moved for summary judgment.

The Tax Court granted the Commissioner's motion, holding that the transactions were devoid of economic substance and therefore created no "loss" for which a deduction could be based. *Fox v. Comm'r*, 56 T.C.M. (CCH) 863 (1988). The Tax Court rejected the appellants' argument that, because they were commodities dealers, section 108(b) of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 108(b), 98 Stat. 494, 630, *as amended by* the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1808(d)(2), (4), 100 Stat. 2085, 2817-18, *reprinted at* I.R.C. (26 U.S.C.) § 1092 note (1988) (hereinafter "section 108(b)"), countenanced the deductions. Section 108*(a)* provides that "any loss" "form[ing] part of a [pre-1982] straddle" "shall be allowed" "if such loss is incurred in a trade or business" *or* "if such loss is incurred in a transaction entered into for profit though not connected with a trade or business." I.R.C. § 1092 note (section 108(a)). Section 108*(b)* provides an irrebuttable presumption that any straddle-related "*loss* incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business." *Id.* (section 108(b)) (emphasis added). The Tax Court held that the irrebuttable trade-or-business-loss presumption of section 108(b) is inapplicable to sham transactions devoid of economic substance, and thus cannot justify the deductions.

We agree. If a transaction is devoid of economic substance — as the transactions involved here undeniably were —, it simply is not recognized for federal taxation purposes, for better or for worse. This denial of recognition means that a sham transaction, devoid of economic substance, cannot

be the basis for a deductible "loss." Section 108, then, which allows deductions for *losses* incurred pursuant to straddle transactions, is inapplicable to straddle transactions devoid of economic substance as there is no "loss" to which the presumption provided by section 108 can apply.

The Tax Court had jurisdiction pursuant to I.R.C. §§ 6214(a), 7442. We have jurisdiction to review final decisions of the Tax Court pursuant to 28 U.S.C. § 1291, and I.R.C. § 7482(a). Inasmuch as the appellants resided in New Jersey at the time of the filing of their respective petitions to the Tax Court, venue for these appeals lies in this court pursuant to I.R.C. § 7482(b)(1)(A). Timely notices of appeal were respectively filed by the taxpayers and the Commissioner.[1]

I.

Facts / Procedural History

The underlying facts of this case are essentially not in dispute. Each appellant claims to be a "commodities dealer" as that term is used in the Code,[2] and each seeks to deduct losses incurred as a result of dealings in option-straddle

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1. The Commissioner, in appeals filed "for protective purposes only," asserts that if this court holds that the taxpayers are entitled to the deductions disallowed by the Tax Court, the appellants are required to offset their claimed losses with corresponding gains reported in the subsequent years of the transactions at issue. In light of our disposition, we do not reach the issue asserted by the Commissioner's appeals.

2. *See* I.R.C. § 1092 note (section 108(f)) (1988) (cross-referencing I.R.C. § 1402(i)(2)(B)); I.R.C. § 1402(i)(2)(B) (1988) (defining "commodities dealer"). Appellants' spouses are parties to these proceedings only by virtue of the filing of joint tax returns. *Fox v. Comm'r*, 56 T.C.M. at 865.

transactions engaged in through brokers operating on the London Metal Exchange in 1975, 1976 and 1977.[3] In a prior, unrelated case, *Glass v. Comm'r*, 87 T.C. 1087 (1986), which we discuss in further detail *infra*, the Tax Court held that the London option-straddle transactions are shams, lacking in economic substance. The petitioners in *Glass* were therefore denied the deductions they claimed as "losses" incurred from the transactions. 87 T.C. at 1177. Significantly, however, the *Glass* court stated that, "[t]he case before us does not involve commodities dealers." *Id.* at 1167.

The parties here stipulated that the "London options transactions at issue in this case are of the same type as those described by the Court in *Glass et al. v. Commissioner*, 87 T.C. No. 68 (Nov. 17, 1986) in the Court's Findings of Fact, Section III A." They thus agree, *per Glass*, that the transactions in this case were shams, lacking economic substance. Appellants nonetheless moved before the Tax Court for summary judgment, arguing that as commodities dealers

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3. Title V of the Economic Recovery Tax Act of 1981 ("ERTA") essentially eliminated the tax benefits of straddle transactions. *See* I.R.C. §§ 1256, 1092 (1988). Essentially, these provisions provide that: (1) regulated futures contracts held by the taxpayer at the close of the year are treated as having been sold on the last business day of the taxable year, with any resulting gain or loss recognized for tax purposes; and (2) losses from other commodity straddles will be recognized only to the extent that such losses exceed unrealized gain on the offsetting position of the straddle. *See Miller v. Comm'r*, 836 F.2d 1274, 1276 n.1 (10th Cir. 1988). By forcing a year-end framework on the straddle transactions, ERTA prevents the two-year period required by straddles to create apparent losses. We discuss the workings of the straddle transactions in further detail *infra*.

they should be permitted to deduct the losses pursuant to section 108(b). Appellants contended that, because they are commodities dealers, under section 108(b) they are presumed to have incurred the straddle-generated losses in a trade or business, and that the transactions in which they engaged therefore cannot be classified as shams devoid of economic substance. They argued that their case was distinguishable from *Glass*, which did not involve commodities dealers. The Commissioner, however, refused to concede that appellants were dealers and the Tax Court held that "[w]e are unable to establish from the stipulated facts that petitioners were 'person[s] who [were] actively engaged in trading [I.R.C. §] 1256 contracts and [were] registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission' during the years at issue." 56 T.C.M. at 866. *See* n.2 *ante*. Since the appellants' commodities dealer status remained in dispute, and since their entitlement to the presumption provided by section 108 revolved around this controverted issue of material fact, the Tax Court denied their summary judgment motion, a disposition not before us on appeal. 56 T.C.M. at 867.

The Commissioner cross-moved for summary judgment on the basis that, as a matter of law, even if the appellants were commodities dealers they were not entitled to the deductions. Relying on its opinion in *Glass* for the proposition that the London option-straddle transactions were devoid of economic substance, and on its opinion in *Cook v. Comm'r*, 90 T.C. 975 (1988), *aff'd*, 931 F.2d 59 (9th Cir. 1991) (table), holding that since the

London option-straddle transactions are economic shams devoid of substance even commodities dealers may not take deductions based on losses sustained in the transactions, the Tax Court granted the Commissioner's motion. The court held that, as a matter of law, even if appellants are commodities dealers, the London option-straddle transactions are shams, 56 T.C.M. at 869, and that since the transactions therefore lack economic substance, they produce no "loss" to which section 108 could apply. *Id.*

The Tax Court based its summary judgment on a legal determination regarding the construction of section 108 and thus our review is plenary. *See Pleasant Summit Land Corp. v. Comm'r*, 863 F.2d 263, 268 (3d Cir. 1988), *cert. denied*, 110 S.Ct. 260 (1989); *Casper v. Comm'r*, 805 F.2d 902, 904 (10th Cir. 1986) (Tax Court's decision to grant summary judgment is legal determination reviewable *de novo* by court of appeals). As the Commissioner was the prevailing party in the Tax Court, we resolve all controverted issues of material fact in favor of the appellants and accordingly, like the Tax Court, for the purposes of this appeal we assume that they are commodities dealers.

II.

The London Option-Straddle Transactions[4]

The London Metal Exchange is a commodity exchange on which cash, futures, and option

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4. The following description is culled primarily from *Glass*, and is included in an attempt to make the transactions at issue understandable. *See Glass v. Comm'r*, 87 T.C. at 1095-1106.

contracts in silver, copper, zinc, tin, and lead are traded. Unlike its counterparts in the United States, such as the Chicago Board Options Exchange, the Exchange does not operate as a clearing house for trades. Rather, all transactions on or subject to Exchange rules are executed on a principal-to-principal basis, meaning that a person purchasing an option or futures contract through a broker/dealer, purchases that contract from the broker/dealer. The broker/dealer does not operate simply as an agent for a third party.

A person can trade on the Exchange in options or futures or both. The three most common forms of options are call, put, and double options. A call option gives the holder/buyer the *right* to buy from the grantor/seller a specified quantity of a commodity at an agreed price at any time before the option's expiration date. A put option gives the holder the *right* to sell a specified quantity of a commodity at an agreed price to the grantor at any time before the option's expiration date. A double option gives the holder the *right* either to sell or buy the underlying commodity at the agreed price before the option's expiration date. Under an option contract the holder has the *right* but not the obligation to purchase or sell the stated commodity at the agreed price and, accordingly, is never at risk for more than the cost of the option.

A futures contract *requires* the buyer to receive, and the seller to deliver, a specified quantity of a given commodity at some future date. Although a futures contract is legally binding between the parties, actual delivery of the underlying commodity rarely occurs. In traded futures and traded options, the contract is normally terminated ("closed out") before actual delivery by offsets, that

is, the execution of an equal and opposite transaction. *See DeMartino v. Comm'r*, 862 F.2d 400, 402 (2d Cir. 1988).

A "straddle" is the simultaneous holding of a contract to buy and a contract to sell the same commodity. *Kirchman v. Comm'r*, 862 F.2d 1486, 1488 (11th Cir. 1989). It consists of the simultaneous holding of a "long position" (a purchased contract) of a commodity for delivery in a future month, and a "short position" (a sold contract) for the identical amount of the same commodity for delivery in a different future month. Each contract is called the "leg" of the straddle. A straddle may be established (or "put on") using either option or future contracts or a combination of both. A "switch" occurs when the holder of a straddle liquidates (*i.e.*, closes out) one leg of the straddle and replaces it by either purchasing or selling (depending on which leg was closed out) an identical quantity of the same commodity for delivery in a different month.

The potential for profit from a straddle derives from changes in the price differential between the legs of the straddle. A straddle in which the long position is held in a month farther out than the short position increases in value if the price differential between the legs widens, and decreases in value if the price differential narrows. Conversely, a straddle in which the short position is held in a month farther out than the long position increases in value if the price differential narrows, and decreases in value if the price differential widens.

On the Exchange, the more common transaction strategy involved what is called the option-straddle

transaction. The option-straddle strategy was based on the use of both option and futures contracts.

The typical London option transaction involved a two-year series of trades in options and futures designed to create losses in the first year and nearly offsetting gains in the second year. In the first year, the following combination of trades was initiated:

(1) an option-straddle was established, consisting of the simultaneous purchase and sale of either a call or put option, or both, for identical quantities of the same commodity with different delivery dates; and

(2) a futures straddle was also established, consisting of the simultaneous purchase and sale of futures contracts for identical quantities of the same commodity with different delivery dates.

Shortly after the option-straddle was established, the legs would be closed out through the purchase and sale of identical offsetting positions. If a call option was purchased, the dealer would sell an identical put option; vice versa for a put option. Because this second set of option contracts would be purchased and sold on a different date than the original option contracts, the prices of the contracts would differ. The result would be that in closing out one leg of the option straddle, the taxpayer would incur a loss, and in closing out the other leg, the taxpayer would incur an approximately equal gain. The loss realized would be deducted as ordinary loss under I.R.C. § 165(c)(2) and offset income from other unrelated sources. The gain would be a short-term capital gain. *See Kirchman*, 862 F.2d at 1488.

Next, to defer recognition of the gain, the "loss" leg of the futures straddle would be closed out in a "switch transaction" through the purchase (or sale) of an identical offsetting position and replaced by a new position with a different delivery date. The net loss on the closed leg of the futures straddle would be reported as a short-term capital loss in the first year and would approximately equal the short-term capital gain incurred in closing out the option position described above. This capital loss would offset the capital gain.

The final step of a typical option-straddle transaction occurred in the subsequent year, although not earlier than six months after the switch. Both legs of the futures straddle would be closed out by offsetting trades, resulting in a gain approximately equal to the loss incurred on the switch in the previous year. The gain incurred would be reported as either short-term or long-term capital gain in the second year of the transaction. Many participants attempted to defer or convert this second-year gain by engaging in a rollover transaction, which meant putting on another futures straddle in the second year of the transaction, subsequently closing out the loss leg in a switch and then closing out the straddle at a gain in the third year. The net general objective of these transactions was the realization of ordinary loss in the first year, and the deferral of capital gain, short- or long-term, to the second year. While paper "losses" were substantial for tax purposes in year-one, ultimate actual losses, if any — and actual gains, if any —, were small by comparison.

III.

The Glass Decision and Section 108

Glass v. Comm'r, 87 T.C. 1087,[5] involved aggregate deficiencies determined by the Commissioner against over 1000 taxpayers totalling in excess of $61 million for the years 1975-1980. The transactions involved the "London option-straddle transaction," and were all virtually identical to the transactions described above. There were two issues before the Tax Court in *Glass*: (1) whether the transactions were shams; and (2) if not, whether the transactions were entered into for profit under the standard set forth in section 108. 87 T.C. at 1091.

The Tax Court in *Glass* found that the London option transaction was without economic substance and was a sham.[6] *Id.* at 1177. It

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5. *Glass* has been affirmed by every circuit court of appeals to which it has been appealed. *Lee v. Comm'r*, 897 F.2d 915 (8th Cir. 1989); *Kielmar v. Comm'r*, 884 F.2d 959 (7th Cir. 1989); *Dewees v. Comm'r*, 870 F.2d 21 (1st Cir. 1989); *Friedman v. Comm'r*, 869 F.2d 785 (4th Cir. 1989); *Keane v. Comm'r*, 865 F.2d 1088 (9th Cir. 1989); *Ratliff v. Comm'r*, 865 F.2d 97 (6th Cir. 1989); *Killingsworth v. Comm'r*, 864 F.2d 1214 (5th Cir. 1989); *Kirchman v. Comm'r*, 862 F.2d 1486 (11th Cir. 1989); *Yosha v. Comm'r*, 861 F.2d 494 (7th Cir. 1988); *Herrington v. Comm'r*, 854 F.2d 755 (5th Cir. 1988), *cert. denied*, 490 U.S. 1065, 109 S.Ct. 2062 (1989).

6. An economic sham is distinguished from a factual sham. A factual sham is one in which the alleged transactions never actually took place. In an economic sham, or a sham in substance, the alleged transactions actually took place, but are nonetheless without economic substance. The Tax Court has defined "sham in substance" as the "expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits." *Falsetti v. Comm'r*, 85 T.C. 332,

therefore determined that the transaction and loss deductions taken pursuant thereto must be disregarded for federal income tax purposes. *Id.* The Tax Court analyzed the entire two-year scheme in detail and concluded that the transactions were "intentional[ly] skew[ed]. . . to realize year one losses. . . ." *Id.* at 1174. The potential for a profit existed but the taxpayers avoided making a profit by intentionally realizing losses in the first year

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347 (1985). The Court of Appeals for the Ninth Circuit has defined a transaction as a sham in substance if it is fictitious or if it has no business purpose or economic effect other than the creation of tax losses. *Sochin v. Comm'r*, 843 F.2d 351, 354 (9th Cir.), *cert. denied*, 488 U.S. 824, 109 S.Ct. 72 (1988). *See also Friedman v. Comm'r*, 869 F.2d 785, 792 (4th Cir. 1989) (same). The Court of Appeals for the Eleventh Circuit has stated that a transaction with the sole function of the production of tax deductions is a sham regardless of the taxpayer's motives. *Kirchman v. Comm'r*, 862 F.2d 1486, 1491 (11th Cir. 1989).

As characterized by at least one court, the economic substance requirement is a sub-test for a sham transaction. That is, there is a two-part test of whether a transaction constitutes a sham. Under this test, a transaction is a sham if: (1) it is not motivated by any economic purpose outside of tax considerations; and (2) it is without economic substance because no real potential for profit exists. *Rice's Toyota World, Inc. v. Comm'r*, 752 F.2d 89, 91 (4th Cir. 1985) (interpreting sham transaction doctrine of *Frank Lyon Co. v. United States*, 435 U.S. 561, 98 S.Ct. 1291 (1978)).

In the case before this court, the London option transactions were found by the Tax Court to be shams and without economic substance – indeed, the parties essentially stipulated to this finding. Although this characterization may be repetitive, the Tax Court's determination that the transactions involved were shams has been uniformly upheld on appeal. *See, e.g., Lee*, 897 F.2d at 915; *Dewees*, 870 F.2d at 21; *Friedman*, 869 F.2d at 785; *Keane*, 865 F.2d at 1088; *Ratliff*, 865 F.2d at 97; *Kirchman*, 862 F.2d at 1486.

which "were not necessary or helpful in profiting from difference gains in petitioners' commodity straddle transactions." *Id.* at 1175-76. Based on its determination that the London options transactions lacked economic substance and were shams, the Tax Court further held that section 108 was "not available to permit loss deductions in the first year of commodity straddle transactions when, as here, the sham involves a series of transactions having no business or profit-making function apart from obtaining tax deductions." *Id.* at 1176.

The Tax Court in *Glass* rejected the taxpayers' argument that, since the tax effects to them of the transactions were sometimes adverse, the Commissioner's allegation that they paid for pre-arranged tax results was unfounded since it failed to account for the ability to offset in future years. The Tax Court found that "[i]t requires no lengthy or elaborate analysis of the facts to demonstrate that petitioners did not enter into these transactions primarily for economic profit," and that "[t]he expected tax benefits completely overwhelm[ed] any potential economic benefits that might have been expected from the straddles." *Id.* at 1162. "[P]etitioners hoped to obtain substantial interest-free loans from the government and achieve more favorable tax rates. At the same time the actual economic gains realized through straddling were either minuscule or non-existent." *Id.* at 1163.

During the course of the proceedings in *Glass*, but before decision was rendered, Congress enacted section 108 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 630, subsection *(a)* of which essentially provided that

losses from the disposition of a leg of a straddle entered into before 1982, were deductible if the straddle was entered into "for profit." Subsection *(b)* provided that straddle transactions of commodities dealers were rebuttably presumed to have been entered into for profit.[7] Section 108 was enacted as a response to the Commissioner's decision to challenge the deductibility of losses incurred in London option transactions, which resulted in an overwhelming amount of litigation. To deal with the backlog of straddle cases, in 1984 Congress passed section 108, with its for-profit presumption.[8]

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7. Section 108 originally provided in part:

> TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.
>
> (a) GENERAL RULE — For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions —
>
> (1) which were entered into before 1982 and form part of a straddle, and
>
> (2) to which the amendments made by title V of the Economic Recovery Tax Act of 1981 do not apply,
>
> any loss from such disposition shall be allowed for the taxable year of the disposition *if such position is part of a transaction entered into for profit.*
>
> (b) PRESUMPTION THAT TRANSACTION ENTERED INTO FOR PROFIT. — For purposes of subsection (a), any position held by a commodities dealer or any person regularly engaged in investing in regulated futures contracts shall be rebuttably presumed to be part of a transaction entered into for profit.

Tax Reform Act of 1984, Pub. L. No. 98-369, § 108(b), 98 Stat. 630 (emphasis added).

8. This history of Section 108 is derived primarily from *Friedman v. Comm'r*, 869 F.2d at 789-91.

The Tax Court first applied the 1984 section 108 in *Miller v. Comm'r*, 84 T.C. 827 (1985). In *Miller*, the Commissioner argued that the phrase "transaction entered into for profit" used in section 108 was unambiguous, was intended to be interpreted identically to the exact same phrase as used in I.R.C. § 165(c), and transactions not entered into *primarily* for profit were therefore not entitled to a loss deduction. A divided Tax Court rejected this argument finding that the language of section 108 was "sufficiently ambiguous to warrant [a] search for interpretive assistance." 84 T.C. at 838. Relying on the legislative history of section 108, the Tax Court found that the phrase "transaction entered into for profit" as used in section 108, allowed deductions for loss when the taxpayer merely had a "reasonable expectation of any profit." Section 108 did not require that profit have been the primary motive for the transaction. *Id.* at 841-42.

The Tax Court's decision in *Miller*, however, was reversed. *Miller v. Comm'r*, 836 F.2d 1274 (10th Cir. 1988). The Court of Appeals for the Tenth Circuit held that section 108 incorporated the "primarily for profit" standard that has emerged as the settled case law of I.R.C. § 165(c)(2). Prior to the court of appeals' decision, however, and in direct response to the Tax Court's holding in *Miller*, Congress retroactively amended section 108 in section 1808(d) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2817. As amended, section 108(a) provides that losses attributable to the disposition of a leg of a commodity straddle are deductible if incurred in a trade or business *or* in a transaction entered into for profit. Section 108(b), in turn, provides an

irrebuttable presumption that losses incurred by a commodities dealer were incurred in a trade or business.[9] As explained by the Tax Court in *Glass*, amended section 108 traces the pattern of the loss provisions of I.R.C. §§ 165(c)(1) and (2),[10] and "makes it clear that losses incurred by commodities dealers trading in commodities are

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9. As amended, Section 108 reads in part:

> TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.
>
> (a) GENERAL RULE. – For purposes of the International Revenue Code of 1954, in the case of any disposition of 1 or more positions –
>
> (1) which were entered into before 1982 and form part of a straddle, and
>
> (2) to which the amendments made by title V of the Economic Recovery Tax Act of 1981 do not apply,
>
> any loss from such disposition shall be allowed for the taxable year of the disposition *if such loss is incurred in a trade or business*, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business.
>
> (b) *LOSS INCURRED IN A TRADE OR BUSINESS.* – For purposes of subsection (a), *any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.*

Tax Reform Act of 1986, Pub. L. No. 99-514, § 1808(d)(1) - (2), 100 Stat. 2817-18 (emphasis added).

10. Those sections relate to I.R.C. § 165(a), which provides:

> (a) General rule.– There shall be allowed as a deduction any loss sustained during the taxable year and not compensated by insurance or otherwise.

Sections 165(c)(1) and (2), I.R.C., in turn provide:

> (c) Limitation on losses of individuals.– In the case

deductible under section 108 since they are losses incurred in a trade or business." Non-dealer investors, on the other hand, must meet the test of loss incurred in a transaction entered into for profit. Thus, in *Glass*, rendering decision based on section 108 as retroactively amended, the Tax Court stated that the deductibility of straddle losses was to be determined by a "primarily for profit" standard. 87 T.C. at 1167.[11] "The case before us," said the court, "does not involve commodities dealers." *Glass*, 87 T.C. at 1167.

IV.

The Cook Decision

Subsequent to its decision in *Glass*, the Tax Court decided *Cook v. Comm'r*, 90 T.C. 975 (1988), *aff'd*, 931 F.2d 59 (9th Cir. 1991) (table). *Cook*

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of an individual, the deduction under subsection (a) shall be limited to –

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business . . . .

11. *See also Dewees v. Comm'r*, 870 F.2d at 29 (Congress enacted section 108 to clarify the application of the general loss deduction rule of section 165 to straddle transactions because Congress wanted to make clear that taxpayers could take a straddle position loss in the year of disposition; prior to the enactment of section 108, the IRS had claimed that the sale of one leg of a straddle was not a closed and completed transaction under which the taxpayer could deduct losses – rather, the taxpayer had to dispose of the other leg to deduct losses under section 165(c)); *DeMartino*, 862 F.2d at 407 (section 108 was intended to overrule the sharply divided Tax Court's decision in *Miller* and to harmonize section 108 with section 165 of the Code).

involved a motion for reconsideration by one of the taxpayers in *Glass* based on a taxpayer's contention that he was in fact a commodities dealer during the tax years at issue in *Glass*. Therefore, according to the taxpayer, the *per se* rule under section 108(b) for commodities dealer losses incurred in a trade or business allowed him to take deductions for losses incurred in the London option transactions, 90 T.C. at 979. For purposes of his argument, the taxpayer conceded that his straddle transactions "lacked economic substance and were a sham in the economic sense," which the Tax Court noted was "consistent with [its] holding in *Glass*." *Id.* at 980.

The *Cook* petitioner's position was, of course, virtually identical to that of the appellants in that both rest on section 108(b). Thus, in this case, the appellants contend as did the petitioner in *Cook*, that a commodities dealer, as a matter of law, is entitled to the deductions for losses on the Exchange because under section 108(b), losses incurred by a commodities dealer in straddle transactions are irrebuttably presumed to have been incurred in a trade or business and under section 108(a) are allowable deductions. *See* 90 T.C. at 979.

The Commissioner's position in *Cook* was identical to the position he takes before this court. The Commissioner argued there that section 108(b) is not applicable to sustain loss deductions claimed from the London option transactions because the transactions were shams in substance, prearranged solely to achieve a tax-avoidance objective. As such, section 108(a) does not apply in determining whether the losses were allowable. Because section 108(a) does not

apply, section 108(b) and its presumption do not come into play. Put another way, the Commissioner argued – and again argues here – that when a transaction lacks economic substance, there is, in the legal sense, no *loss* for purposes of section 108(a), and the presumption of section 108(b), therefore, simply does not apply.

In *Cook*, the Tax Court conceded that its statement in *Glass* that the case did not involve commodities dealers was "inaccurate" at least as to Cook. The Tax Court nonetheless did not allow his deductions. It held that, even as to commodities dealers, "it is appropriate before applying the per se rule of section 108(b) to enquire whether straddle transactions were fictitious, prearranged, or otherwise in violation of the rules of the exchange, and if so, whether there were losses actually incurred." 90 T.C. at 986. *See also id.* n.6. Since the London option transactions were unquestionably prearranged to generate a loss, reasoned the court, the *per se* rule of section 108(b) was unavailable to Cook.

In reaching its determination in *Cook*, the Tax Court considered it appropriate to consider the legislative history surrounding section 108(b) which "expressly provides a caveat to the per se rule." 90 T.C. at 984. The House Report regarding amended section 108(b) states that the section 108(b) "presumption would not be available in any cases where the trades were fictitious, *prearranged*, or otherwise in violation of the rules of the exchange in which the dealer is a member." H.R. Rep. 426, 99th Cong., 1st Sess. 911 (1985) (emphasis added).

The Tax Court stated that the "prearranged" language of the Report "casts a shadow on the

otherwise bright line parameters of the per se rule." 90 T.C. at 985. Based on the language in the House Report, the Tax Court determined that, where the losses are prearranged, the issue arises whether the losses were actually incurred, which is a necessary precondition to the application of the *per se* rule. The Tax Court reiterated its finding in *Glass* that the losses putatively incurred were lacking in economic substance and therefore were shams. "In effect, then, no losses were incurred." Thus, the *per se* dealer rule is not available since section 108(b) only applies to "any loss" incurred by a commodities dealer. *Id.* at 985. The Tax Court further noted that "we think it would be highly anomalous to disallow loss deductions to over 1,000 petitioners claiming them under the London Option Transaction, as we have done in *Glass*, while allowing them to petitioner, even though a dealer, on the self-same transaction." *Id.* at 985. Accordingly, the holding in *Cook* stands for the proposition that the *per se* dealer rule will be unavailable not only in situations involving fictitious transactions but will also be unavailable to dealers involved in actual transactions, "prearranged" to lack economic substance.

V.

Glass, Cook, and Section 108 As Applied To This Case

Appellants' basic position before this court is that section 108(b) was intended to treat dealers as a favored class and to make the "profit motive" test inapplicable to them. They argue that section 108(b) allows them to deduct losses incurred pursuant to straddle transactions, *even if those transactions are unquestionably economic shams.*

Accordingly, if dealers incur losses in transactions designed solely to generate tax losses, they are nonetheless deductible because section 108(b) precludes the Commissioner from challenging dealers' profit motive.

The legislative history to section 108 as amended allegedly reflects a congressional intent in accord with this position. Appellants claim that section 108 was originally enacted in a congressional effort to "break the log jam" of cases in which the Commissioner challenged loss deductions based on options or future straddle transactions.[12] The amendments to section 108, particularly the addition of the irrebuttable presumption regarding commodities dealers in subsection (b), are said to reflect a congressional intent to give commodities dealers special treatment regarding straddle transactions. According to appellants, the amendment to section 108 was intended, and is understood, to have given straddle-loss-deduction amnesty to everyone engaged in the commodities trading business. Thus, appellants urge this court to hold that section 108(b) applies to provide an irrebuttable presumption that losses stemming from straddle transactions engaged in by dealers before 1982 are deductible even though such transactions were designed solely to create tax losses. We decline to accept this invitation.

Per Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266 (1935), it is settled federal tax law that for transactions to be recognized for tax purposes they must have economic substance. Therefore,

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12. By one estimate, at least 4,400 straddle cases were pending before the Tax Court in the early 1980's. *Miller*, 84 T.C. at 855. There were over 1,400 original petitioners in *Glass* alone. *Glass*, 87 T.C. 1087-90.

economic substance is a *prerequisite* to the application of any Code provisions allowing deductions, including section 108.

The London option transactions involved lacked economic substance because they were prearranged transactions intended solely to generate tax benefits in the form of deductible losses. Thus, as they lacked economic substance, they cannot be recognized for tax purposes. Because they are not recognized for tax purposes, section 108 does not even come into play. Section 108(b) applies to "any loss" deducted under section 108(a), but section 108(a) cannot be applied to transactions lacking in economic substance because, in tax terms, a transaction lacking in economic substance cannot result in a "loss." The option-straddles in this case, then, lacking economic substance and therefore non-recognizable for tax purposes, produced no "losses" to which section 108(a) can apply, thus precluding any application of section 108(b).

We agree that the irrebuttable presumption in amended section 108(b) was intended to, and did, eliminate any profit motive inquiry for straddle transactions as to dealers. We agree also that this amendment reflected Congress' concern with the inherent difficulty in determining a dealer's profit motive with respect to any particular trade because a dealer is involved in so many trades. Amended section 108(b), therefore, was enacted to avoid this difficulty. Thus, section 108(b) prevents the Commissioner from disallowing loss deductions by pointing to evidence that any one dealer did not have a profit motive when engaging in a straddle transaction.

We see no basis to hold, however, that the amendment to section 108(b) was intended to

override the long-standing requirement that transactions have economic substance to be qualified for loss deduction status. *See DeMartino*, 862 F.2d at 407; *Cook*, 90 T.C. at 984-85. As explained in *DeMartino*, elimination of a profit motive inquiry does not "prevent the inquiry into the economic substance of a dealer's commodity trading." The Tax Court and numerous appellate courts have held that section 108 does *not* apply to sham commodity transactions devoid of economic substance. *See, e.g., Glass*, 87 T.C. at 1176; *Keane*, 865 F.2d at 1093; *Sochin*, 843 F.2d at 353-54 n.6. The fact that such a transaction involves a commodities dealer is neither a logical nor a statutorily-authorized reason to alter the economic substance rule.

For instance, in *DeMartino v. Comm'r*, 862 F.2d at 400, the taxpayer, a commodities trader, invested in crude oil future straddles executed on the New York Cotton Exchange, a regulated American exchange. The market in crude oil futures was extremely thin and the brokers were able effectively to control the contract prices. They executed these contracts in a prearranged plan designed to create tax losses without any real possibility of gain or loss. The Commissioner assessed deficiencies which the Tax Court upheld, finding that the transactions were shams and that the losses sustained therein could not be recognized for federal tax purposes. 862 F.2d at 404. On appeal, the taxpayer claimed that he was entitled to the deductions under section 108(b) since he was a dealer. The taxpayer claimed that since his trades were not factual shams, but were cleared through a regulated American exchange, they had economic substance and, even if they did

not have economic substance, section 108(b) applied to allow the deductions.

The court of appeals rejected this argument. The court first held that, even though the trades were cleared on a regulated American exchange, they lacked economic substance because they were prearranged to result in nothing more than tax losses. 862 F.2d at 406. The court then rejected the argument that section 108(b) nonetheless entitled the taxpayer/dealer to the deductions. The court stated that in enacting section 108(b):

> Congress eliminated the profit motive inquiry in cases involving dealers because of the inherent difficulty involved in making such an inquiry, *but it did not prevent inquiry into the economic substance of a dealer's commodity trading.*

862 F.2d at 407 (emphasis added).

The court further stated that section 108(a) does not apply to straddle transactions that are shams and since section 108(a) cannot apply to sham transactions, section 108(b) does not apply. The court defined a sham as a transaction that "is fictitious or . . . has no business purpose or economic effect other than the creation of tax deductions." *Id.* at 406.[13]

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13. Appellants claim that *DeMartino* is distinguishable from this case because it involved transactions that were factual, rather than economic, shams. In essence, they argue that section 108(b) would be unavailable to sustain deductions on transactions that never actually occurred, but as long as the trades do in fact occur, even if prearranged to create tax losses, section 108(b) allows dealers to take deductions based on them. This attempt to distinguish *DeMartino* is faulty, for in *DeMartino*, the trades *did* actually occur but were devoid of economic substance because they were designed solely to create losses. 806 F.2d at 406.

And quite recently, in *Cook v. Comm'r*, 90 T.C. 975, the Tax Court held specifically that even as to commodities dealers involved in the London option transactions, the presumption provided by section 108(b) is not available where the transactions are devoid of economic substance. As discussed above, the Tax Court held that, even as to commodities dealers, before applying section 108(b), a straddle transaction must have economic substance. *Id.* at 986. The Tax Court found that since the London option transaction was "deliberately prearranged," section 108(b) was unavailable to sustain the petitioner's deductions. *Id.*

The Tax Court considered the legislative history surrounding section 108(b) and particularly focused on the language in the House Report noted above which states that the section 108(b) "presumption would not be available in any cases where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member." H.R. Rep. No. 426, 99th Cong, 1st Sess. 911 (1985). The presumption in section 108(b), then, absolves dealers of the need to prove any profit motive so long as the transactions involved are not fictitious, *prearranged*, or otherwise in violation of the exchange's rules. 90 T.C. at 985-86.

Based on this language, the *Cook* court determined that, where the losses are prearranged they are non-recognizable for tax purposes. Such non-recognizable losses lack economic substance and are therefore shams. In essence, losses pursuant to sham transactions are not losses for tax purposes. Therefore, the *per se* dealer rule is not available to sustain deductions based on the

alleged losses since section 108(b) only applies to "any *loss*" incurred by a commodities dealer – and any "*loss*" must be an *actual* loss.

We accept the reasoning in *DeMartino* and *Cook*, there being no principled distinction between them and the present case as to facts or legal consequences. The basic rule of law is that taxation is based upon substance, not form. *Gregory*, 293 U.S. at 469-70, 55 S.Ct. at 267-68. The holdings in *DeMartino* and *Cook*, and the position taken by the Commissioner in this case are in accord with that rule. The result urged on this court by appellants would allow a small group of taxpayers – commodities dealers who engaged in sham straddle transactions before 1982 – to claim "losses" when none in fact were sustained. We do not believe Congress intended this unseemly result, which would undermine the power and duty of the Commissioner and the courts to look beyond the mere forms of transactions to their economic substance and to apply the tax laws accordingly. *Forseth v. Comm'r*, 845 F.2d 746, 749 (7th Cir. 1988).

The economic substance doctrine has been consistently applied by the courts for many years in a variety of tax situations. There is no sound reason to conclude that, in enacting the amendments to section 108(b), Congress meant to abandon the doctrine. *See, e.g., Frank Lyon Co. v. United States*, 435 U.S. 561, 98 S.Ct. 1291 (1978) (court looked at economic substance or reality of sale and leaseback transactions); *Knetsch v. United States*, 364 U.S. 361, 81 S.Ct. 132 (1960) (interest expense deductions disallowed because only thing of substance to be realized from transaction was tax deduction); *Commissioner v. Court Holding Co.*,

324 U.S. 331, 65 S.Ct. 707 (1945) (recognizing step transaction doctrine, whereby courts must consider all steps of transaction in light of entire transaction, so that substance of transaction will control over form of each step).

In essence, the appellants would have this court find that, because of a backlog in the court system, Congress abandoned the economic substance requirement as to straddle transactions involving dealers, along with some 40 years of jurisprudence regarding the economic substance doctrine, and instead gave these sham transactions post-facto blessing. This is an unreasonable conclusion, and one which as a basic tenet of statutory interpretation should not be reached. *See Dewees*, 870 F.2d at 35-36 (it is unreasonable to believe that Congress in enacting section 108 wished to weaken the sham in substance doctrine). *See also Haggar Co. v. Helvering*, 308 U.S. 389, 394, 60 S.Ct. 337, 339-40 (1940). If Congress had intended to grant such a windfall it could and, one must assume, would have done so in a manner free from any doubt or ambiguity.

Faced with overwhelming and well-reasoned case law, *see, e.g.*, n.15 *infra*, and less than unambiguous statutory authority, the appellants nonetheless contend that section 108(b) does apply to sustain their sham transaction deductions. They urge that the legislative history of section 108 proves that Congress, in creating the irrebuttable presumption of profit-motives for dealers, intended to allow dealers to deduct losses pursuant to sham transactions such as those involved in this case. According to the appellants, Congress clearly intended to sacrifice the tax revenue which would

be received pursuant to disallowing deductions sought by dealers in its desire to clear the Tax Court's docket of cases involving straddle transactions. In its attempt to do so, it amended section 108(b) to remove the profit motive requirement as to dealers because of the inherent difficulty in determining the existence or lack thereof of profit motive for dealers in numerous individual transactions. That is, for expediency's sake, Congress gave dealers unique treatment as far as pre-1982 straddle transactions, granting them an unquestionable right to deduct losses based on straddle transactions, in an effort to clear the docket of these cases.

Although the legislative history of section 108 does reveal congressional concern with the logjam of straddle cases before the Tax Court, the idea that Congress intended to grant dealers the right to deduct losses pursuant to sham transactions is unpersuasive. Both the 1984 and 1986 versions of section 108(b) reflect congressional recognition that dealers conduct numerous trades, as a result of which there is an "inherent difficulty in distinguishing tax-motivated straddle transactions from profit-motivated straddle transactions . . . ." H.R. Rep. No. 426, 99th Cong., 1st Sess. at 910-11 (1985). Thus, it is quite possible that in amending section 108(b), Congress was willing to give up a certain amount of revenue from straddle transactions because it recognized the inherent difficulty in proving a dealer's subjective profit motive as to any one transaction. This, however, is a far cry from saying that Congress intended to allow dealers to take deductions based on straddle transactions totally devoid of any purpose beyond the generation of tax deductions and passed a

statute by which there would be absolutely no inquiry into the substantial tax validity of such transactions.

The much more logical conclusion is that reached by the court of appeals in *DeMartino* – *viz*, that section 108 eliminated the profit motive inquiry in cases involving dealers because of the inherent difficulty in making such an inquiry, but it did not prevent inquiry into the economic substance of a dealer's commodities trading. 862 F.2d at 407. There is ample support for this proposition. *See Knetsch v. United States*, 364 U.S. at 365, 81 S.Ct. at 134-35 (Court put aside district court's finding concerning motive in determining whether a transaction was a sham); *Forseth*, 845 F.2d at 748 (if a transaction is a sham, then such "niceties" as whether it was primarily for profit are not involved); *Kirchman*, 862 F.2d at 1492 (once a court determines that a transaction is a sham, no further inquiry into intent is necessary); *Dewees*, 870 F.2d at 35 (a taxpayer cannot deduct a sham transaction loss, irrespective of his subjective profit motive).[14] Furthermore, we see no internal inconsistency in the *DeMartino* conclusion as it

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14. In their reply brief to this court, appellants claim that the Supreme Court recently held in *Cottage Savings Ass'n v. Comm'r*, U.S. , 111 S. Ct. 1519 (1991), that "transactions will not be denied effect as wanting in economic substance if the transactions are bona fide." They argue that since the transactions here actually occurred, they were bona fide and cannot be found wanting in economic substance. This argument mischaracterizes the holding in *Cottage* and has no merit in this case. In *Cottage*, the Court rejected the Commissioner's argument that the transactions at issue lacked economic substance and therefore could not sustain the deductions taken. There the transactions involved the exchange by a financial institution of its interests in one

does not follow that Congress by restraining one inquiry intended that a conclusion on another point must follow.

Finally, although the majority of the cases construing the London option transactions did not involve commodities dealers, a number of them do involve section 108 in general. These cases have uniformly held that when a transaction is a sham, it is outside the purview of section 108. Since the application of section 108*(b)* depends on the availability of section 108*(a)*, the fact that this case involves commodities dealers is not sufficient to distinguish it from the overwhelming majority of cases which have found section 108 unavailable to the London option transactions.[15] These cases

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group of residential mortgages for another lender's interests in a different group of residential mortgages. The mortgages given over had a face value of some $2 million more than the fair market value of those received, based on which the petitioner took a loss deduction. As relevant to this case, the Court rejected the Commissioner's contention that the losses could not be sustained because they lacked economic substance because the Commissioner failed to meet its burden of proof on this claim. That is, the Commissioner relied on a case in which a finding of lack of economic substance was based on the determination that the transaction was not conducted at arm's length and because the taxpayer never relinquished control over the securities on which he based his deduction. The Commissioner in *Cottage* failed in any regard to contend or prove that the exchange involved was not at arm's length or that Cottage did not actually gave up control over the mortgages it exchanged. Therefore, the Court rejected the Commissioner's claim that the transaction lacked economic substance. *Cottage* cannot be read for the proposition that, as long as a transaction is bona fide, *i.e.*, actually occurred, it cannot be denied economic substance.

15. *See, e.g., Lee v. Comm'r*, 897 F.2d 915, 917 (8th Cir. 1989) ("[t]he London option transactions . . . lacked economic substance. As such, they are outside the purview of . . .

confirm our belief that Congress did not enact section 108(b) as a safe harbor for commodities dealers who engage in transactions devoid of economic substance, prearranged to create losses. In essence, the problem with the appellants' case is that they were really trading tax consequences rather than silver.

VI.

Conclusion

The Tax Court correctly determined that the option-straddle transactions at issue in this case are shams, devoid of economic substance, and thus any losses generated thereby cannot be the basis for deductions. Section 108(a), which allows *loss* deductions for straddle transactions, does not apply to countenance deductions for a sham transaction from which no true "loss" occurs, and the trade-or-business-loss presumption of section 108(b) cannot be claimed by commodities dealers unless they have sustained an actual loss. Therefore, we will affirm the decisions of the Tax Court and will dismiss the appeals of the Commissioner.

[section] 108 . . ."); *Friedman v. Comm'r*, 869 F.2d at 791 (section 108 is inapplicable to transactions constituting economic shams); *Keane v. Comm'r*, 865 F.2d at 1092-93 (because the London option transactions had no economic substance, section 108 did not apply); *Kirchman v. Comm'r*, 862 F.2d at 1494 (since the transaction as a whole, not just the first year losses, were designed solely to produce tax benefits, the transaction was a sham in substance and section 108 does not apply); *Sochin v. Comm'r*, 843 F.2d at 353-54, n.6 (section 108 does not apply until the court determines that the transaction is not a sham); *Enrici v. Comm'r*, 813 F.2d 293, 295, n.1. (9th Cir. 1987) (same); *Mahoney v. Comm'r*, 808 F.2d 1219, 1220 (6th Cir. 1987) (same); *Glass*, 87 T.C. at 1176 (section 108 unavailable to permit loss deductions in year one of sham transaction).

A True Copy:
Teste:

Clerk of the United States Court of Appeals
for the Third Circuit

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 90-1813, 90-1814, 90-1815,
90-1835, 90-1836, 90-1837

CHARLES S. LERMAN and BARBARA LERMAN,

Cross-Appellants at No. 90-1835
Appellees at No. 90-1813

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant at No. 90-1813
Cross-Appellee at No. 90-1835

JOSEPH L. FRAITES and EVELYN FRAITES,

Cross-Appellants at No. 90-1836
Appellees at No. 90-1814

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant at No. 90-1814
Cross-Appellee at No. 90-1836

DWIGHT B. MASSEY and JOANN V. MASSEY,

Cross-Appellants at No. 90-1837
Appellees at No. 90-1815

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellant at No. 90-1815
Cross-Appellee at No. 90-1837

On Appeal from the United States Tax Court
T.C. Nos. 79-10239, 80-22295, 81-23614

Argued June 6, 1991

Nos. 90-1813, 90-1814, 90-1815,
90-1835, 90-1836, 90-1837

Present: SLOVITER, *Chief Judge*, GREENBERG and HIGGINBOTHAM, *Circuit Judges*

JUDGMENT

These causes came on to be heard on the record from the United States Tax Court, and were argued by counsel June 6, 1991.

On consideration whereof, it is now here ordered, adjudged and decreed by this Court that the decisions of the said Tax Court in these causes, be, and the same are hereby affirmed. It is further ordered that appeal Nos. 90-1813, 90-1814 and 90-1815 are dismissed. Costs on appeal taxed against the taxpayers in appeal Nos. 90-1835, 90-1836 and 90-1837 and against the Commissioner

in appeal Nos. 90-1813, 90-1814 and 90-1815. All of the above in accordance with the opinion of this Court.

ATTEST:

/s/Sally Mrvos

Clerk

July 18, 1991

Certified as a true copy and issued in lieu of a formal mandate on August 8, 1991

Test: /s/Sally Mrvos

Clerk, United States Court of Appeals
for the Third Circuit.

JACK M. FOX AND MARLISS S. FOX, ET AL., Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent[1]

Docket Nos. 3453-79; 10069-79; 10233-79; 10234-79; 10236-79; 10237-79; 10238-79; 10239-79; 10240-79; 10241-79; 10242-79; 10243-79; 10244-79; 13246-80; 13247-80; 13248-80; 21879-80; 22240-80; 22291-80; 22292-80; 22293-80; 22294-80; 22295-80; 22296-80; 22297-80; 23476-81; 23477-81; 23478-81; 23479-81; 23480-81; 23614-81; 31359-81; 974-82; 13919-82; 13920-82; 16675-83; 21394-83.

COUNSEL: Samuel Brodsky, for the petitioners in docket Nos. 3453-79, 10069-79 and 21879-80.

Elias Rosenzweig, Stanley Klein and Michael J. Weitzner, for the petitioners in all other dockets.

Victoria Wilson Fernandez and George H. Soba, for the respondent.

NIMS, Chief Judge: This case is before the Court on petitioners' motion for summary judgment and respondent's cross-motion for summary judgment filed pursuant to Rule 121, Tax Court Rules of Practice and Procedure, on May 1, 1987, and June 3, 1987, respectively.

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[1] Cases of the following petitioners are consolidated herewith: Reed Clark and Audrey I. Clark, docket Nos. 10240-79, 22291-80 and 23479-81; Ralph G. and Jean Kazi, docket Nos. 10233-79, 22296-80 and 23478-81; Jack M. Fox and Marliss S. Fox, docket Nos. 10069-79 and 21879-80; Terence J. Horn and Jean Horn, docket Nos. 10236-79, 13248-80 and 16675-83; Dwight B. Massey and Joann V. Massey, docket Nos. 10241-79, 22297-80 and 23614-81; Joseph L. Fraites and Evelyn S. Fraites, docket Nos. 10243-79, 22295-80 and 23476-81; Dominick A. Cademartori and Jean E. Cademartori, docket Nos. 10244-79, 22293-80, 23480-81 and 21394-83; Daniel Gutman and Judith Gutman, docket Nos. 10234-79 and 13247-80; Hilary P. Gardner and Judith C. Gardner, docket Nos. 10238-79, 22240-80 and 31359-81; Charles H. Falk and Joan A. Falk, docket Nos. 10242-79, 22292-80, 974-82 and 13920-82; Charles S. Lerman and Barbara Lerman, docket Nos. 10239-79 and 13246-80; Arturo Sterling, docket No. 10237-79; Arturo Sterling and Lydia Sterling, docket Nos. 22294-80, 23477-81 and 13919-82.

Respondent determined the following deficiencies in and additions to petitioners' Federal income taxes:

Docket No.	Year	Deficiency	Addition to Tax Sec. 6653(a)
3453-79	1974	87,809.00	-
10069-79	1975	239,511.00	-
10233-79	1975	501,133.00	-
10234-79	1975	104,034.00	-
10236-79	1975	88,429.00	-
10237-79	1975	1,339,103.00	-
10238-79	1975	515,853.00	-
10239-79	1975	155,041.00	-
10240-79	1975	1,874,215.00	-
10241-79	1975	672,734.00	-
10242-79	1975	689,265.00	-
10243-79	1975	1,654,083.00	-
10244-79	1975	191,566.00	-
13246-80	1976	258,416.00	12,921.00
13247-80	1976	79,839.00	3,992.00
13248-80	1976	16,832.00	842.00
21879-80	1976	459,735.00	-
22240-80	1976	720,918.00	-
22291-80	1976	2,684,599.00	-
22292-80	1976	982,189.00	-
22293-80	1976	205,152.00	-
22294-80	1976	871,515.00	-
22295-80	1976	2,062,269.00	-
22296-80	1976	664,905.00	-
22297-80	1976	616,521.00	-
23476-81	1977	6,211,615.00	-
23477-81	1977	532,023.00	-
23478-81	1977	2,279,247.00	-
23479-81	1977	8,251,560.00	-
23480-81	1977	364,896.00	-
23614-81	1977	4,384,235.00	-
31359-81	1977	301,742.50	-
974-82	1977	724,640.58	-

13919-82	1978	195,019.00	-
13920-82	1978	161,366.00	-
16675-83	1977	82,626.00	-
	1978	39,613.00	-
	1979	5,313.00	-
21394-83	1978	87,606.00	-
	1979	205,160.00	-
	1980	74,953.00	-

After concessions,[2] the sole issue for decision is whether the per se profit motivation rule section 108(b)[3] of the Tax Reform Act of 1984 (Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630), as amended by section 1808(d) of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2817) (hereinafter section 108), applies to protect dealers from a finding that their straddle transactions are shams devoid of economic substance.

BACKGROUND

At the time their petitions were filed, the States of residence of the respective petitioners were as follows:

Name	States of Residence
Reed and Audrey I. Clark	New York
Ralph and Jean Kazi	New York
Jack M. and Marliss S. Fox	Hawaii
Terence J. and Jean Horn	New York
Dwight B. and Joann V. Massey	New Jersey

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[2] Three cases, docket Nos. 23478-81, 23480-81 and 21394-83 also involve unrelated issues. "Piggyback" agreements have been entered into regarding these issues so that we need not consider them at this time. All other adjustments have been resolved.

[3] See Appendix A for text of section 108 of Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630, as amended by section 1808(d) of the Tax Reform Act of 1986, Pub. L. 99-514. 100 Stat. 2085, 2817.

Joseph L. and Evelyn Fraites	New Jersey
Dominick and Jean Cademartori	New York
Daniel and Judith Gutman	New York
Hilary and Judith Gardner	New York
Charles and Joan Falk	New York
Charles and Barbara Lerman	New Jersey
Arturo Sterling	New York

All of the petitioner-wives are parties to these proceedings only by virtue of their filing joint returns with petitioner-husbands. All of the petitioner-husbands (hereinafter petitioners) were associated with Czarnikow-Rionda Company, Inc., a subchapter S corporation, Czarnikow-Rionda Trading Company, Inc. or Rionda de Pass Ltd. (hereinafter referred to collectively as "Rionda"). During the years in issue, Rionda was a member of the New York Coffee and Sugar Exchange (Exchange). The Exchange is now known as the New York Coffee, Sugar and Cocoa Exchange. The Exchange has been designated as a contract market by the Commodity Futures Trading Commission (CFTC) and Rionda was registered as a futures commission merchant with the CFTC.

During the years at issue, Rionda regularly traded in physical sugar, sugar futures and options on sugar futures for its own account. It also acted as a broker in the purchase and sale of sugar futures and options on sugar futures. These transactions took place on the Exchange as well as on foreign exchanges.

Various petitioners were shareholders or officers of Rionda. Each petitioner was registered with the CFTC as an employee of Rionda. Petitioners Clark, Fraites, Falk and Massey were members of the Exchange during the years in issue, although Exchange rules may have limited full exercise of their membership privileges. Petitioner Gardner became a member of the Exchange in April, 1976.

At all times during the years in issue, Rionda maintained substantial positions in physical sugar and in sugar futures contracts on the Exchange. On a daily basis it purchased and sold

sugar future contracts on the Exchange. Petitioners Clark, Fraites, Massey, Falk, Gardner, Sterling, Gutman, Horn, Lerman and Kazi participated in the decision-making processes of Rionda's business and executed futures trades on a directed or discretionary basis for customers of Rionda.

The issue for decision did not, however, arise from petitioners' option trading activities on behalf of Rionda. Rather, the issue before us concerns the consequences of various silver and tin option and future straddles which petitioners transacted on the London Metal Exchange (LME). Petitioners traded silver options and futures through Lonconex and tin option and futures through Bear Stearns on the LME. Petitioners' straddle transactions were designed to produce ordinary losses in the initial year and short-term capital gains in the subsequent years. The short-term capital gains would then be converted into long-term capital gains through executing new futures straddles in silver, copper and other commodities on other domestic or foreign exchanges.

Petitioners have stipulated that the London options transactions at issue in this case are of the same type as those described by the Court in "Section III A" of its Findings of Fact in *Glass v. Commissioner*, 87 T.C. 1087, 1104-1106 (1986), affd. sub nom. *Herrington v. Commissioner*, 854 F.2d 755 (5th Cir. 1988), affd. sub nom. *Yosha v. Commissioner*, F.2d (7th Cir., Nov. 8, 1988):

> III. The London Options Transactions
>
> A. In General
>
> We turn now to a description of the actual transactions at issue in these consolidated cases. As previously noted, a typical London options transaction took place over a 2-year period in the form of either an option straddle or an option hedge. An option-straddle transaction,[11] the more prevalent

[11] The term "option-straddle transaction" as used herein denotes a type of trading strategy based upon the use of both options and futures contracts. The term is to be distinguished from the term "option straddle" which is simply a straddle consisting of option contracts.

trading strategy, was initiated by the following combination of trades in the first year of the transaction:

(1) An option straddle was put on, consisting of the simultaneous purchase and sale (grant) of either a call or put option (or both), for identical quantities of the same commodity with different delivery dates; and

(2) A futures straddle was also put on, consisting of the simultaneous purchase and sale of futures contracts for identical quantities of the same commodity with different delivery dates.

Shortly after the option straddle was put on, the legs would be closed out through the purchase and sale of identical offsetting positions. The premium (purchase price) paid to buy an offsetting option which closed out the sold (granted) option would exceed the premium that had been received on the granted option, resulting in an overall net loss on the sold option leg of the straddle. Conversely, the premium received on the sale of an offsetting option which closed out the purchased option would exceed the premium that had been paid for the purchased option, resulting in an overall net gain on the purchased option leg of the straddle. The net loss and gain, which were approximately equal, would be reported as an ordinary loss and short-term capital gain for the first year of the transaction. Since the expected tax result in the first year was generally an ordinary loss, such loss could be used to offset ordinary income from unrelated sources.

Next, in a switch transaction, the so-called loss leg of the futures straddle would be closed out through the purchase (or sale) of an identical offsetting position and replaced by a new position with a different delivery date. (Because an inverse relationship normally exists between the legs of a futures straddle, one

leg will have an unrealized loss while the other will have an unrealized gain.) The net loss on the closed leg of the futures straddle would be reported as a short-term capital loss in the first year of the transaction and would approximately equal the short-term capital gain incurred on closing out the purchased option position.

The final step of a typical option-straddle transaction occurred in the subsequent year, although not earlier than 6 months after the switch. Both legs of the futures straddle would be closed out by offsetting trades, resulting in a gain approximately equal to the loss incurred on the switch transaction in the previous year. The gain incurred would be reported as either a short-term or long-term capital gain in the second year of the transaction.

The second trading strategy employed by broker-dealers was the option-hedge transaction. In an option-hedge transaction, the sale of a call and/or put option was hedged by the purchase of a futures contract (to hedge the call) and/or the sale of a futures contract (to hedge the put). Shortly thereafter, the option positions would be closed out at a net loss through the purchase of an identical offsetting call and/or put option. Simultaneously with the purchase of the closing option positions, futures contracts would be executed to hedge the previously purchased and/or sold futures, thus forming one or more futures straddles. Finally, in the following year, the futures straddles would be closed out at a gain approximately equal in amount to the loss incurred on the sold options.

Because both the option-straddle transaction and the option-hedge transaction strategies resulted in a capital gain in the second year of the transaction, many petitioners attempted to defer the gain (and possibly convert it into long-term gain) to the subsequent

year by engaging in a rollover transaction. A rollover transaction simply entailed putting on another futures straddle in the second year of the transaction, subsequently closing out the loss leg in a switch, and then closing out the straddle at a gain in the following year.

Petitioners reported the following ordinary losses from their London options transactions, which respondent disallowed:

Petitioner	1975	1976	1977
Clark	($2,124,000)	$ 3,408,382)	-
Kazi	($ 518,000)	($ 971,754)	($ 202,320)
Fox	($ 263,913)	($ 606,564)	-
Horn	—	($ 140,975)	($ 155,118)
Massey	($ 608,000)	($ 970,195)	-
Fraites	($2,016,000)	($2,480,548)	-
Cademartori	($ 127,260)	($ 306,367)	($ 28,986)
Gutman	—	($ 140,172)	-
Gardner	($ 767,752)	($1,014,768)	($ 755,914)
Falk	($ 767,752)	($1,014,768)	($ 755,914)
Lerman	—	($ 195,168)	-
Sterling	($ 607,000)	($ 882,000)	-

DISCUSSION

Petitioners' motion for summary judgment is premised upon the fact that they were dealers in commodities within the meaning of section 108(b) at the time they executed their straddle transactions, a difference they believe critical in distinguishing their situation from that of the nondealers we addressed in Glass v. Commissioner, supra. Respondent, however, fails to concede that petitioners were dealers within the meaning of section 108(f) and Internal Revenue Code (I.R.C.) section 1402(i)(2)(B). We are unable to establish from the stipulated facts that petitioners were "person[s] who [were] actively engaged in trading [I.R.C.] 1256 contracts and [were] registered with a domestic board of trade which is designated as a contract market by the Commodities Futures Trading Commission" during the years at issue.

I.R.C. section 1402(i)(2)(B) and section 108(f). Therefore, petitioners' dealer status, a fact material to petitioners' position, remains in dispute. Because this Court may only grant summary judgment if "there is no genuine issue as to any material fact," we must, as petitioners concede on brief, deny petitioners' motion. Rule 121(b). See *Naftel v. Commissioner*, 85 T.C. 527, 529 (1985).

Respondent's cross-motion for summary judgment is based upon the legal theory that irrespective of whether petitioners are dealers or nondealers, the straddle transactions in question are shams devoid of economic substance. He asserts that since the purported transactions are shams in substance, the per se rule of section 108(b) does not apply to petitioners. Therefore, the ordinary losses generated by the straddle transactions should be disallowed for tax purposes as a matter of law. For purposes of evaluating the merit of the sham in substance theory, respondent concedes that petitioners were dealers within the meaning of section 108 and that the transactions factually occurred. Thus, there remains no genuine issue of material fact with respect to the issue of sham in substance. Respondent, however, continues to contest petitioners' dealer status and the factual occurrence of the straddle transactions in all contexts other than that of his legal theory. See *McLain v. Commissioner*, 67 T.C. 775, 778-779 (1977), and cases cited therein. Accordingly, the scope of our inquiry is limited to (1) whether petitioners' straddle transactions were shams in substance as a matter of law and if so, (2) assuming petitioners' dealer status, whether the per se presumption of section 108(b) will nonetheless act upon the putative losses arising from such transactions to characterize them as deductible "trade or business related."

In *Cook v. Commissioner*, 90 T.C. 975 (1988), this Court recently considered the impact of section 108(b) on commodities dealers who engage in straddle transactions which are devoid of economic substance. In our opinion, we specifically disallowed the deduction of putative losses incurred in the *Glass* straddle transactions by taxpayers who qualified as dealers within the meaning of section 108(f). 90 T.C. at 976-977. We believe that

the principles we establish in Cook require us to grant respondent's cross-motion for summary judgment.

We note at the outset that because the parties submitted their briefs prior to our entering the *Cook* decision, many of the assertions they now advance are identical to those previously evaluated and answered by the Court in Cook. Rather than repeat the detailed reasoning of *Cook* at this time, we feel it sufficient to limit our summary to those points petitioners reassert in opposition to the cross-motion presently before this Court.

We begin our analysis by considering whether the transactions in question are shams in substance. Unlike the taxpayers in *Cook*, who consistent with our holding in *Glass* stipulated that the straddle transaction at issue was a sham in substance (90 T.C. at 979-980), petitioners have not explicitly conceded this point. Therefore, we must examine the stipulated facts to determine the presence or absence of economic substance. Specifically, we must determine whether the transactions at issue in this case, which were stipulated to be of the same type as those described by the Court in *Glass*, are distinguishable from transactions we have previously found to lack economic substance.

As we stated in *Glass v. Commissioner*, 87 T.C. at 1174, the grand focus of our attention is the entire tax straddle scheme and not each separate straddle. See *Smith v. Commissioner*, 78 T.C. 350, 390-391 (1982). The stipulation submitted by the parties contains detailed information regarding the losses allegedly generated by closing out the "loss legs" of the various straddles. We are, however, somewhat troubled by the parties' failure to introduce into the stipulation specific information regarding the offsetting capital gain legs of the straddle transactions. Given the mandate that we view the factual materials presented and omitted and the inferences to be drawn from such materials and omissions in the light most favorable to the party opposing the motion in determining the absence of a material fact (*Jacklin v. Commissioner*, 79 T.C. 340, 344 (1982)), it might be argued

that the omission of capital gain information raises a material issue of fact that would prevent us from concluding as a matter of law that petitioners' transactions were shams in substance.

We do not, however, consider respondent's failure to produce a specific record of the offsetting straddle gains to be fatal. On the contrary, because petitioners stipulated that the capital gain incurred on closing out the second leg of the straddles was "approximately equal to the loss incurred * * * in the previous year," any inference we must make regarding the amount of petitioners' capital gains must be limited to an amount which would approximately offset the losses incurred on the prior straddle leg. We conclude, therefore, that whatever petitioners' actual gains were, they must by virtue of petitioners' stipulation necessarily fall within the parameters of the straddle transactions we found in *Glass* and *Cook* to be prearranged and shams in substance. The fact that the entire transaction produces a nominal net gain, an inference we draw in favor of petitioners, will not impute substance into an otherwise sham transaction. On the contrary, we specifically observed in *Glass* that a "very small" net economic gain might result from the closed straddle transaction (87 T.C. at 1157). However, after comparing the potential nominal economic gains with the prearranged and "very substantial" tax losses anticipated in the first year of the straddle, we concluded that the *Glass* transactions lacked economic substance. The parties have stipulated that petitioners' straddle transactions are similar to the generic transactions executed in *Glass*. We find no salient distinction in petitioners' transactions which would cause us to alter the characterization we affixed in Glass. Accordingly, we find as a matter of law that petitioners' transactions are devoid of economic substance.

Our inference that petitioners' closed-out straddle produced nominal if any economic gain is consistent with the conduct the parties demonstrated in motioning this Court for summary judgment. Petitioners' dockets were removed from the trial calendar based upon the representation that the remaining controversies at issue therein could be resolved by our determining the narrow legal issue of "whether the holding of *Glass* applied to

persons who were dealers under Section 108(b)." Because the parties stipulated that their transactions were similar to the generic *Glass* transactions, we believe they implicitly represented that their transactions, at best, produced only nominal gains. The extent to which the parties referred to *Glass* in their arguments persuades us that they thoroughly examined and understood the transactions involved therein. One would expect that if significant net economic gains – straddle gains minus straddle losses minus commissions – were generated by petitioners' transactions, petitioners' counsel would have brought this fact to our attention in the stipulation. No such distinguishing representation was made. We are therefore convinced that our inference regarding the extent of petitioners' economic gains comports with economic realities.

We next consider whether petitioners' assumed dealer status will trigger the application of section 108(b) to transmute putative losses into bona fide losses incurred in a trade or business. Like the taxpayers in Cook, petitioners place heavy emphasis upon our opinion in *King v. Commissioner*, 87 T.C. 1213 (1986) (Court reviewed), an opinion entered after *Glass* and prior to *Cook*. Marlowe King was a registered member of the Chicago Mercantile Exchange (CME), a domestic board of trade subject to regulation by the Commodities Futures Trading Corporation (CFTC). King was a commodities dealer within the meaning of I.R.C. section 1402(i)(2)(B) and section 108(f). King entered into various gold straddles during 1980 and 1981. King liquidated the loss legs of these straddles in 1980 and deducted a $1,452,900 short-term capital loss. The Commissioner disallowed the loss. He asserted in the statutory notice of deficiency that "The transactions at issue were either shams or devoid of the substance necessary for recognition for federal income tax purposes." 87 T.C. at 1216. King petitioned this Court for a summary judgment ruling that the claimed losses were deductible under section 108. King's affidavit in support of his motion detailed facts supporting the bona fide nature of his trading in gold contracts. 87 T.C. at 1217. The Commissioner opposed this motion on three grounds:

(1) Taxpayer failed to address the threshold issue of whether the transactions were shams;

(2) Taxpayer failed to show that he is entitled to the presumption under section 108(b) of the Tax Reform Act of 1984 and Temporary Regulation Section 1.165-13T; and

(3) Even if taxpayer were entitled to the presumption, a trial would nevertheless be required to resolve the "for profit" issue which is inherently factual. 87 T.C. at 1216.

The Commissioner, however, failed to allege or support any facts tending to demonstrate that King's trading transactions were shams in any sense. We held that "Under these circumstances, respondent has not shown that there is a genuine issue of sham for trial." 87 T.C. at 1217. We then granted King's motion for summary judgment based upon a finding that the specific gold straddles executed by King were not fictitious.

Petitioners assert that "The King analysis teaches that the 'economic sham' of *Glass* is inapplicable to taxpayers who qualify as dealers under Section 108." Petitioners misread our analysis. As we pointed out in *Cook* (90 T.C. at 982), we expressly refrained in King from drawing any conclusions as to what the result might be under other circumstances. In footnote 8, page 1219, of *King*, we said:

The per se rule of sec. 108(b) would not preclude us from finding for respondent in another case. The legislative history of the provision makes clear that it was not intended to apply "where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member." H. Rept. 99-426, at 911 (1985). [1986-3 C.B. (Vol. 2), at 911.] See also *DeMartino v. Commissioner*, T.C. Memo. 1986-263 [affd. F.2d (2d Cir., Nov. 23, 1988)].

In contrast with his unsupported allegation of sham in *King*, the Commissioner specifically alleged in *Cook* (90 T.C. at 980) that the prearranged and fictitious nature of the *Glass* straddles

caused the transactions to be shams in substance. After assuming the *Glass* transactions were not fictitious, we concluded that they were nonetheless prearranged. We then concluded that Congress never intended section 108(b) to automatically characterize all dealer derived straddle losses as losses incurred in a trade or business. Rather, we determined that Congress contemplated that "the presumption [that a straddle loss was incurred in a trade or business] would not be available in any cases were the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member." 90 T.C. at 984 citing H. Rept. 99-426, 1986-3 C.B. (Vol. 2) 911. Consistent with this Congressional intent, we held that:

> it is appropriate before applying the per se rule of section 108(b) to enquire whether straddle transactions were fictitious, prearranged, or otherwise in violation of the rules of the exchange, and if so, whether there were losses actually incurred. [Footnote ref. omitted.] Since the straddle transactions in Glass were prearranged, causing the transactions to lack economic substance, petitioner incurred no losses to which the per se rule can be applied. * * * [90 T.C. at 986.]

As discussed above, petitioners stipulated that their straddle transactions were similar to the generic *Glass* schemes we found to be prearranged and shams in substance. See *Cook v. Commissioner*, 90 T.C. at 985-986. Accordingly, we find as a matter of law that petitioners' straddle transactions produced no losses to which the per se rule of section 108(b) can be applied. See *DeMartino v. Commissioner*, F.2d (2d Cir., Nov. 23, 1988), affg. T.C. Memo. 1986-263 (holding that the Court may inquire into the economic substance of a dealer's commodity trading in determining whether section 108(b) is applicable). Likewise, since the straddle transactions were shams, gains reported by petitioners in the latter years do not constitute taxable income to them.

To reflect the foregoing,

Appropriate orders will be issued and decisions will be entered under Rule 155 in docket Nos. 3453-79, 10069-79, 10233-79, 10234-79, 10236-79, 10237-79, 10238-79, 10239-79, 10240-79, 10241-79, 10242-79, 10243-79, 10244-79, 13246-80, 13247-80, 13248-80, 21879-80, 22240-80, 22291-80, 22292-80, 22293-80, 22294-80, 22295-80, 22296-80, 22297-80, 23476-81, 23477-81, 23479-81, 23614-81, 31359-81, 974-82, 13919-82, 13920-82, 16675-83.

APPENDIX A

Section 108 of Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630, as amended by section 1808(d) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2817.

SEC. 108. TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.

(a) GENERAL RULE. — For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions -

(1) which are entered into before 1982 and form part of a straddle, and

(2) to which the amendments made by title V of such Act [Economic Recovery Tax Act of 1981] do not apply, any loss from such disposition shall be allowed for the taxable year of the disposition if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business.

(b) LOSS INCURRED IN A TRADE OR BUSINESS. — For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.

(c) NET LOSS ALLOWED. – If any loss with respect to a position described in paragraphs (1) and (2) of subsection (a) is not allowable as a deduction (after applying subsections (a) and (b)), such loss shall be allowed in determining the gain or loss from dispositions of other positions in the straddle to the extent required to accurately reflect the taxpayer's net gain or loss from all positions in such straddle.

(d) OTHER RULES. – Except as otherwise provided in subsections (a) and (c) and in sections 1233 and 1234 of such Code, the determination of whether there is recognized gain or loss with respect to a position, and the amount and timing of such gain or loss, and the treatment of such gain or loss as long-term or short-term shall be made without regard to whether such position constitutes part of a straddle.

(e) STRADDLE. – For purposes of this section, the term "straddle" has the meaning given to such term by section 1092(c) of the Internal Revenue Code of 1954 as in effect on the day after the date of the enactment of the Economic Recovery Tax Act of 1981, and shall include a straddle all the positions of which are regulated futures contracts.

(f) COMMODITIES DEALERS. – For purposes of this section, the term "commodities dealer" means any taxpayer who -

(1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B) of the Internal Revenue Code of 1954 (as added by this subtitle), or

(2) was a member of the family (within the meaning of section 704(e)(3) of such Code) of an individual described in paragraph (1) to the extent such member engaged in commodities trading through an organization the members of which consisted solely of -

(A) 1 or more individuals described in paragraph (1), and

(B) 1 or more members of the families (as so defined) of such individuals.

(g) REGULATED FUTURES CONTRACTS. – For purposes of this section, the term "regulated futures contracts" has the meaning given to such term by section 1256(b) of the Internal Revenue Code of 1954 (as in effect before the date of enactment of this Act).

(h) SYNDICATES. – For purposes of this section, any loss incurred by a person (other than a commodities dealer) with respect to an interest in a syndicate (within the meaning of section 1256(e)(3)(B) of the Internal Revenue Code of 1954) shall not be considered to be a loss incurred in a trade or business.

UNITED STATES TAX COURT

CHARLES S. LERMAN and BARBARA LERMAN,	)	
Petitioners,	)	
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	Docket No. 10239-79
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed December 15, 1988, and the Stipulation previously filed with the Court, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That the following statement shows the petitioners' income tax liability for the taxable year 1975:

1975

Tax liability	$129,730.00
Tax assessed and paid 4/15/76	$ 58,500.00
Deficiency to be assessed	$ 71,230.00
Tax paid after mailing of notice of deficiency, but not assessed (credit) 4/15/84	$ 36,448.00
Unpaid deficiency	$ 34,782.00

(Signed) ARTHUR L. NIMS, III
Judge

Entered: July 31, 1990

UNITED STATES TAX COURT

JOSEPH L. FRAITES and EVELYN FRAITES,	)	
Petitioners,	)	
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	Docket No. 22295-80
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed December 15, 1988, and the Stipulation previously filed with the Court, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That the following statement shows the petitioners' tax liability for the taxable year 1976:

1976

Tax liability	$2,004,245.00
Tax assessed and paid 10/15/77	$ 216,094.00
Deficiency to be assessed	$1,788,151.00
Tax paid after mailing of notice of deficiency, but not assessed	
Dec. 31, 1986	$ 237,000.00
Dec. 31, 1987	$ 56,250.00
Jan. 03, 1989	$ 100,000.00
Unpaid deficiency	$1,394,901.00

(Signed) ARTHUR L. NIMS, III
Judge

Entered: July 31, 1990

UNITED STATES TAX COURT

DWIGHT B. MASSEY and JOANN V. MASSEY,	)	
Petitioners,	)	
v.	)	
	)	Docket No.
COMMISSIONER OF INTERNAL REVENUE,	)	23614-81
Respondent.	)	

DECISION

Pursuant to the opinion of the Court filed December 15, 1988, and the Stipulation previously filed with the Court, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED AND DECIDED: That there is an overpayment in income tax due to the petitioners for the taxable year 1977 in the amount of $275,170.00, which was paid on June 15, 1978, and for which amount a claim for refund could have been filed, under the provisions of I.R.C. §6511(b)(2) on June 12, 1981, the date of the mailing of the notice of deficiency.

(Signed) ARTHUR L. NIMS, III
Judge

Entered: July 31, 1990

UNITED STATES TAX COURT

JACK M. FOX and MARLISS S. FOX, et al.,	)	Docket Nos. 3453-79, 13246-80, 23476-81, 10069-79, 13247-80,
Petitioners,	)	23477-81, 10233-79, 13248-80, 23478-81,
v.	)	10234-79, 21879-80, 23479-81, 10236-79,
COMMISSIONER OF INTERNAL REVENUE,	)	22240-80, 23480-81, 10237-79, 22291-80,
Respondent.	)	23614-81, 10238-79, 22292-80, 31359-81, 10239-79, 22293-80, 974-82, 10240-79, 22294-80, 13919-82, 10241-79, 22295-80, 13920-82, 10242-79, 22296-80, 16675-83, 10243-79, 22297-80, 21394-83, 10244-79,

STIPULATION OF FACTS

PREAMBLE

The below-signed parties agree to this First Stipulation of Facts for Motion for Summary Judgment pursuant to the terms of the preamble, unless specifically expressed otherwise herein. For the purpose of the Motion for Summary Judgment only, all stipulated facts shall be conclusive, all stipulated exhibits shall be considered authentic, all copies shall be considered electronic reproductions of the originals and shall be treated as if originals. Neither party shall be bound by any item stipulated to as a fact except for purposes of this summary judgment motion.

This stipulation is not to be construed as a concession by the respondent that the transactions at issue actually occurred.

1. At the time of the filing of the petition, the petitioners' addresses were as follows:

(a) Clark, Reed & Audrey I.
Valentine's Lane
Old Brookville, New York

(b) Kazi, Ralph & Jean
99 Mamaroneck Road
Scarsdale, New York

(c) Fox, Jack M. & Marliss S.
P. O. Box 4304,
Kawaihae, Hawaii 96743

(d) Horn, Terence J & Jean
Taylor Road
Mount Kisco, New York 10549

(e) Massey, Dwight & Joann V.
154 Beechwood Road
Ridgewood, New Jersey 07450

(f) Fraites, Joseph L. & Evelyn
747 Johnston Drive
Watchnung, New Jersey 07060

(g) Cademartori, Dominick & Jean
30 Renfrew Road
Spring Valley, New York 10977

(h) Gutman, Daniel & Judith
6 C Blue Sea Lane
Kings Point, New York 11024

(i) Gardner, Hilary & Judith
283 Wheatley Road
Old Westbury, New York 11568

(j) Falk, Charles & Joan
19 Pound Hollow Road
Glen Head, New York 11545

(k) Lerman, Charles & Barbara
30 Galloping Hill Circle
Holmdel, New Jersey 07733

(l) Sterling, Arturo & Lydia
c/o Czarnikow-Rionda, Co., Inc.
120 Wall Street
New York, New York 10005

2. Attached as the following Joint Exhibits are copies of the petitioners' federal income tax returns for the years at issue in these cases:

Exhibit No.	*Petitioners*	*Docket Nos.*	*Tax Years*
1-A	Reed & Audrey I. Clark	10240-79	1975
2-B	Reed & Audrey I. Clark	22291-80	1976
3-C	Reed & Audrey I. Clark	23479-81	1977
4-D	Ralph and Jean Kazi	10233-79	1975
5-E	Ralph and Jean Kazi	22296-80	1976
6-F	Ralph and Jean Kazi	23478-81	1977
7-G	Jack M. & Marliss S. Fox	10069-79	1975
8-H	Jack M. & Marliss S. Fox	21879-80	1976
9-I	Terence J. & Jean Horn	10236-79	1975
10-J	Terence J. & Jean Horn	13248-80	1976
11-K	Terence J. & Jean Horn	16675-83	1977
12-L	Terence J. & Jean Horn	16675-83	1978
13-M	Terence J. & Jean Horn	16675-83	1979
14-N	Dwight B. & Joann V. Massey	10241-79	1975
15-O	Dwight B. & Joann V. Massey	22297-80	1976
16-P	Dwight B. & Joann V. Massey	23614-81	1977
17-Q	Joseph L. & Evelyn Fraites	10243-79	1975
18-R	Joseph L. & Evelyn Fraites	22295-80	1976
19-S	Joseph L. & Evelyn Fraites	23476-81	1977
20-T	Dominick & Jean Cademartori	10244-79	1975

21-U	Dominick & Jean Cademartori	22293-80	1976
22-V	Dominick & Jean Cademartori	23480-81	1977
23-W	Dominick & Jean Cademartori	21394-83	1978
24-X	Dominick & Jean Cademartori	21394-83	1979
25-Y	Dominick & Jean Cademartori	21394-83	1980
26-Z	Daniel and Judith Gutman	10234-79	1975
27-AA	Daniel and Judith Gutman	13247-80	1976
28-AB	Hilary & Judith Gardner	10238-79	1975
29-AC	Hilary & Judith Gardner	22240-80	1976
30-AD	Hilary & Judith Gardner	31359-81	1977
31-AE	Charles & Joan Falk	10242-79	1975
32-AP	Charles & Joan Falk	22292-80	1976
33-AG	Charles & Joan Falk	974-82	1977
34-AH	Charles & Joan Falk	13920-82	1978
35-AI	Charles & Barbara Lerman	10239-79	1975
36-AJ	Charles & Barbara Lerman	13246-80	1976
37-AK	Arturo & Lydia Sterling	10237-79	1975
38-AL	Arturo & Lydia Sterling	22294-80	1976
39-AM	Arturo & Lydia Sterling	23477-81	1977
40-AN	Arturo & Lydia Sterling	13919-82	1978

3. Attached as the following Exhibits are copies of the notices of deficiency for the years at issue in these cases:

Exhibit No.	*Petitioners*	*Docket Nos.*	*Tax Years*
41-AO	Reed & Audrey I. Clark	10240-79	1975
42-AP	Reed & Audrey I. Clark	22291-80	1976
43-AQ	Reed & Audrey I. Clark	23479-81	1977
44-AR	Ralph and Jean Kazi	10233-79	1975
45-AS	Ralph and Jean Kazi	22296-80	1976
46-AT	Ralph and Jean Kazi	23478-81	1977
47-AU	Jack M. & Marliss S. Fox	10069-79	1975
48-AV	Jack M. & Marliss S. Fox	21879-80	1976
49-AW	Terence J. & Jean Horn	10236-79	1975
50-AX	Terence J. & Jean Horn	13248-80	1976
51-AY	Terence J. & Jean Horn	16675-83	1977-1979
52-AZ	Dwight B. & Joann V. Massey	10241-79	1975

53-BA	Dwight B. & Joann V. Massey	22297-80	1976
54-BB	Dwight B. & Joann V. Massey	23614-81	1977
55-BC	Joseph L. & Evelyn Fraites	10243-79	1975
56-BD	Joseph L. & Evelyn Fraites	22295-80	1976
57-BE	Joseph L. & Evelyn Fraites	23476-81	1977
58-BF	Dominick & Jean Cademartori	10244-79	1975
59-BG	Dominick & Jean Cademartori	22293-80	1976
60-BH	Dominick & Jean Cademartori	23480-81	1977
61-BI	Dominick & Jean Cademartori	21394-83	1978-1980
62-BJ	Daniel and Judith Gutman	10234-79	1975
63-BK	Daniel and Judith Gutman	13247-80	1976
64-BL	Hilary & Judith Gardner	10238-79	1975
65-BM	Hilary & Judith Gardner	22240-80	1976
66-BN	Hilary & Judith Gardner	31359-81	1977
67-BO	Charles & Joan Falk	10242-79	1975
68-BP	Charles & Joan Falk	22292-80	1976
69-BQ	Charles & Joan Falk	974-82	1977
70-BR	Charles & Joan Falk	13920-82	1978
71-BS	Charles & Barbara Lerman	10239-79	1975
72-BT	Charles & Barbara Lerman	13246-80	1976
73-BU	Arturo & Lydia Sterling	10237-79	1975
74-BV	Arturo & Lydia Sterling	22294-80	1976
75-BW	Arturo & Lydia Sterling	23477-81	1977
76-BX	Arturo & Lydia Sterling	13919-82	1978

4. Respondent's statutory notices issued in these cases disallowed tin and silver options ordinary losses claimed by the petitioners from transactions which they engaged in on the London Metal Exchange (hereinafter "LME").

5. The silver options and futures were traded through Lonconex on the LME.

6. The tin options and futures were transacted on the LME through Bear Stearns.

7. London options transactions at issue in this case are of the same type as those described by the Court in *Glass et al. v. Commissioner*, 87 T.C. No. 68 (Nov. 17, 1986) in the Court's findings

of Fact, Section III A. Through the use of such transactions, ordinary losses were incurred in the initial years and capital gains were realized in the subsequent years.

Short term capital gains which were generated by the transactions were subsequently converted into long term capital gains through new futures straddles in silver, copper and other commodities initiated on U. S. exchanges, such as the Commodities Exchange Inc. ("Comex") and foreign exchanges. Some of these futures straddles were closed by petitioners Massey, Fraites, Sterling, Clark, Cademartori and Kazi either by taking delivery of physical commodities in settlement of long future positions and delivering them against the short futures position, or by taking delivery and selling the physical commodity, realizing long term capital gains.

The following is a schedule of ordinary losses incurred with regard to the transactions at issue and disallowed by the respondent:

SCHEDULE OF DISALLOWED LOSSES WITH RESPECT TO THE TRANSACTIONS AT ISSUE

Petitioners	*1975*	*1976*	*1977*
Clark (Losses)	($ 2,124,000)	($ 3,408,382)	
Kazi (Losses)	($ 518,000)	($ 971,754)	($ 202,320)
Fox (Losses)	($ 263.913)	($ 606,564)	
Horn (Losses)		($ 140,975)	($ 155,118)
Massey (Losses)	($ 608.000)	($ 970,195)	
Fraites (Losses)	($ 2,016,000)	($ 2,480,548)	
Cademartori (Losses)	($ 127,260)	($ 306,367)	($ 28,986)
Gutman (Losses)		($ 140,172)	
Gardner (Losses)	($ 767.752)	($ 1,014,768)	($ 755.914)
Falk (Losses)	($ 767,752)	($ 1,014,768)	($ 755,914)
Lerman (Losses)		($ 195.168)	
Sterling (Losses)	($ 607,000)	($ 882.000)	

9. All of the petitioner-wives are parties to these proceedings only by virtue of their filing joint returns with petitioner-husbands.

10. All of the petitioner-husbands (hereinafter petitioners) in these cases were during the years at issue either employee/officers or shareholders, or both. of Czarnikow-Rionda Company. Inc., a subchapter S corporation, and/or, after September, 1980. of Czarnikov Rionda Trading Co., Inc., and/or of Rionda de Pass Ltd. (collectively "Rionda").

11. During the years at issue, Rionda regularly traded in physical sugar, and sugar futures and options on sugar futures for its own account. It also acted as a broker for its customers in the purchase and sale of sugar futures and options on sugar futures.

12. Rionda, during the years at issue, was a member of the New York Coffee and Sugar Exchange (hereinafter "the Exchange"). The Exchange is now known as the New York Coffee, Sugar and Cocoa Exchange. Attached as Exhibits 77-BY, 7B-BZ and 79-CA are copies of relevant rules of the Exchange.

13. Under the Rules of the Exchange, a corporation cannot obtain membership in its own right, but must have membership privileges conferred upon it by an individual member of the Exchange.

14. Corporation privileges were conferred upon Rionda on the Exchange based upon the membershp privileges of Falk and Massey during the years at issue. Based upon Clark's membership, corporation privileges were conferred upon Sugar Cane Growers, a customer of Rionda, during the years at issue. Based upon Fraites' membership, corporation privileges were conferred upon Rionda de Pass Ltd., during the years at issue.

15. The Exchange has been designated as a contract market by the Commodity Futures Trading Commission (hereinafter "CFTC") since July 18, 1975. Attached as Exhibit 80-CB is a

copy of the Commodity Exchange Act, the Commodity Futures Trading Commission Act of 1974, the Futures Trading Act of 1978, the Futures Trading Act of 1982, and the Futures Trading Act of 1986.

16. During the years at issue Rionda was registered as a Futures Commission Merchant with the C.F.T.C.

17. The following petitioners were all of the shareholders of Rionda from 1975 - 1976: Clark, Massey, Gardner, Sterling, Fraites, Falk, Fox, Cademartori, and Kazi.

18. In 1977, the shareholders of Rionda were Clark, Massey, Gardner, Sterling, Fraites, Falk, Cademartori and Kazi.

19. From 1975 - 1977, the following petitioners were officers of Rionda:

President/Chairman of the Board	Reed Clark
Executive Vice President/President	Joseph L. Fraites
Vice President/Executive Vice President	Charles H. Falk
Vice President	Dwight B. Massey
Vice President	Hilary P. Gardner
Vice President	Arturo Sterling
Vice President	Ralph B. Kazi
Vice President	Dominick Cademartori
Assistant Vice President	Daniel Gutman

20. Petitioners Horn and Lerman were assistant vice presidents in 1977.

21. Petitioner Fox was a Vice President of Rionda through 1976 and Managing Director/Chairman of the Board of Rionda de Pass, Ltd., a British subsidiary of Rionda.

22. The following petitioners were individual members of the Exchange during the years at issue:

Petitioner	*Membership Period*	*Membership No.*
Clark	1/1/74 to 12/31/80	091
Falk	1/1/74 to 12/31/80	251
Fox	2/8/62 to 9/26/76	120
Fraites	1/1/74 to 12/31/80	256
Massey	1/1/74 to 12/31/80	031
Gardner	4/14/76 to 5/30/83	055

23. None of the remaining petitioners was a member of any Exchange during the years at issue.

24. Prior to January 1975, membership status with the Exchange automatically included floor trading rights if the member met the financial requirements of a floor trader. Effective January 1975, the Exchange required separate applications for membership and floor trading privileges, however, existing members as of January 1975 were entitled to retain their floor trading privileges, subject to the financial requirements of floor traders. See Exhibit 81-CC, letter from the Exchange to Samuel Brodsky. dated January 30, 1987.

25. None of the petitioners has been registered with the CFTC as a floor broker.

26. A floor broker is one who effects transactions on the floor of the Exchange for other parties. Registration of floor brokers was required under the Commodities Exchange Act, at least as early as 1970.

27. Floor traders, on the other hand, are members who generally trade for their own account. Before the CFTC entered the scene in mid-1975, the operation of the Exchange was less structured than it became after the advent of the CFTC, and a member, acting as a floor trader, was permitted access to the floor to effect transactions for himself or his own company and could do so upon signing the register. Petitioners have no copies of applications for floor trading privilege numbers (i.e., badges). and none were required before mid-1975. Even today, a member

may have access to the floor upon written request to effect a trade. Each of the petitioners who was an Exchange member from time to time prior to mid-1975 (and possibly on one or more occasions thereafter) traded on the floor for Rionda.

28. Reed Clark was the President of Rionda until 1976 and thereafter Chairman. He was the Chief Executive Officer of Czarnikow-Rionda Company, Inc., and/or Czarnikow-Rionda Trading Company, Inc., (collectively, "Rionda") throughout the period 1974 to 1980. He exercised all the functions of such office. He was a member of the Exchange from 1955 and through 1980. He frequently served as a member of one or more committees of the Exchange.

29. Joseph L. Fraites was Executive Vice President of Rionda commencing in 1969 until 1976, and thereafter President. He was the Chief Operating Officer of Rionda and, as such, exercised ultimate immediate authority with respect to Rionda's affairs. Mr. Fraites became a member of the Exchange in 1955 and continues as a member to date. He has served in numerous capacities at the Exchange and acted as Chairman of the Board of the Exchange for many years.

30. Arturo Sterling was a Vice President of Rionda from 1974 through 1980 and was responsible for trade in raw and refined sugar with Latin American countries and the Republic of the Philippines. Mr. Sterling was not a member of the Exchange or any other exchange during the period in question.

31. Charles H. Falk was Executive Vice President of Rionda and was Rionda's chief trader. Mr. Falk became a member of the Exchange in 1970 and continues as such to date. He has held positions on many committees of the Exchange, including Membership, Arbitration, Control, Margin, Option and Adjudication. He has been a director of the Clearing House since 1971 and has been Chairman of the Board of the Exchange at various times.

32. H. Paul Gardner was a Vice President of Rionda and a senior trader with particular responsibilities for trade with the Far East. In 1975, Mr. Gardner's responsibilities were expanded to include European trading and, in August 1978, he moved to London where he became the director in charge of trading for Rionda's London subsidiary, Rionda de Pass Ltd. Mr. Gardner served in London in that capacity until May of 1983. He has been a member of the Exchange since April 1976 and has served on its Business Conduct Committee, Membership Committee, Control Committee, Sugar Committee, Nominating Committee, World Spot Price Roster, Special Working Group to Study Options, and has represented the Exchange at United Nations sponsored International Sugar Agreement meetings. Mr. Gardner's initial transactions and losses arose in 1975 when he was not a member of the Exchange, or any other exchange.

33. Dwight B. Massey was a Vice President of Rionda throughout the 1974-1980 period and his principal duties consisted of marketing raw sugar to U.S. refineries and industrial users; and planning and aiding in the purchase of sugar for U.S. destinations. Mr. Massey became a member of the Exchange on January 9, 1970 and continued as such through 1980 and thereafter. He has served on many committees of the Exchange.

34. Dominick A. Cademartori was a Vice President of Rionda and in charge of its Shipping/Invoice Department. As such, he supervised the activities of the department which conducted the physical movements of sugar, chartering of vessels, establishing letters of credit, procuring insurance, negotiating shipping documents, invoicing. and the like. Mr. Cademartori was not a member of the Exchange or any other Exchange during the periods at issue.

35. Jack M. Fox was a Vice President and one of the senior traders for Rionda. For some time prior to January 1, 1974 and thereafter through December 31, 1976, Mr. Fox served as Managing Director of Rionda de Pass Ltd., a wholly-owned subsidiary of Rionda, and thereafter, from January 1, 1977 through November 20, 1978, as Chairman of its Board. His duties

included the management, direction, trading and overall strategy of Rionda de Pass Ltd. Mr. Fox was a member of the Exchange until August 26, 1976.

36. Ralph A. Kazi was a Vice President of Rionda and its sugar analyst. His principal duties consisted of the collection and evaluation of data (as, for example, acreages planted for sugarcane and beets, yields, extraction rates), consumption, exports, imports, inventories, legislation and government regulations — domestic and foreign — which would affect the price of sugar, forecasting trends in production and consumption and balances between the two, providing information to customers of Rionda, and development of customer relations. Mr. Kazi was not a member of the Exchange or any other Exchange during the period at issue.

37. Daniel Gutman was initially Assistant Vice President and later a Vice President of Rionda. His principal responsibility consisted of trade in sugar with producers in Argentina, Colombia, El Salvador, Guatemala and Honduras. Mr. Gutman was not a member of the Exchange or any other Exchange during the periods at issue.

38. Charles Lerman was a Vice President of Rionda. He was responsible for execution of Rionda's trading decisions and for the execution of the futures business of Rionda's customers. Mr. Lerman was not a member of the Exchange or any other Exchange during the periods at issue.

39. Terence J. Horn was an Assistant Vice President of Rionda and was one of its senior futures traders. Subsequent to 1977 he also engaged in trading of physical sugar on behalf of Rionda. Mr. Horn was not a member of the Exchange, or any other exchange during the periods at issue.

40. Rionda employed one or two floor brokers, none of whom is a petitioner in these cases, to execute trades on behalf of Rionda on the Exchange during the periods at issue in these cases. Theodore G. Jackson was one of the floor brokers employed by

Rionda since December 17, 1973, when he acquired a membership on the Exchange. Clifford S. Evans was the other floor broker employed by Rionda for the years in issue, acquiring his membership on August 26, 1976.

41. During the period July 8, 1975 through November 19, 1980, the following petitioners were registered with the CFTC as "associated persons," in the employ of Rionda:

(a) Reed Clark;
(b) Ralph Kazi;
(c) Joseph Fraites;
(d) Arturo Sterling;
(e) Charles Falk;
(f) Dwight B. Massey;
(g) Dominick Cademartori;
(h) Daniel Gutman;
(i) Charles Lerman; and,
(j) Terence Horn

42. During the period July 8, 1975 through March 13, 1980, petitioner Hilary Gardner was registered with the CFTC as an "associated person," in the employ of Rionda.

43. Petitioner Jack M. Fox was registered with the Commodity Futures Trading Commission as a "foreign associated person," in the employ of Rionda as of January 6, 1976.

44. During the period in issue, none of the petitioners, other than as a shareholder/officer/employee of Rionda, traded for the account of any person or entity other than of customers of Rionda and Rionda itself.

45. At all times during the years 1975 through 1981, Rionda maintained substantial positions in physical sugar and in sugar futures contracts on the Exchange.

46. During such period, Rionda, on a daily basis, purchased and sold sugar future contracts on the Exchange as hedges

against contracts for the purchase or sale of physical sugar, for speculation purposes, as arbitrage positions against future positions which it held on other sugar exchanges such as Paris or London, and/or straddles.

47. Petitioners Clark, Fraites, Massey, Falk, Gardner, Sterling, Fox, Gutman, Horn, Lerman and Kazi participated in the following activities on behalf of Rionda:

(A). The decision making process by which Rionda's long and short term physical and futures positions were determined;

(B). Within the position parameters determined as set forth in (A), exercised discretion in purchasing and selling physical sugar and sugar futures on the Exchange and on other exchanges such as Paris and London; and,

(C). Exercised discretion in purchasing and selling physical sugar and sugar futures on the Exchange and other exchanges for the purposes of conducting Rionda's business as set forth in paragraph 46 of this Stipulation.

(D). Executed futures trades on a directed or discretionary basis on the Exchange for customers of Rionda.

With the exception of Gutman, the non-shareholder-petitioners had more limited authority than the shareholder-petitioners in the above-described decision making process.

48. Petitioner Dominick A. Cademartori advised the petitioners specified in paragraph 47 of the shipping and other costs affecting their purchase and sales decisions.

49. Attached as Exhibit 82-CD is a copy of a letter dated February 2, 1977 from the C.F.T.C. and a letter dated February 10, 1977 from Rionda.

50. If respondent's motion for summary judgment is granted, the determination of the deficiency owed by a petitioner should take into account the following:

(a) Where the statutory notice specifies "increase in capital gains due to commodity transactions" or words having a similar effect, and such gains relate to the commodities transactions at issue, such increases should be eliminated.

(b) Net capital gains and/or losses which are related to commodity straddle transactions and are involved in years for which petitions have been filed should be eliminated.

(c) Such other adjustments should be made as may be necessary to give effect in these cases to the decision of the Court in the *Glass* case that capital gains in year two and thereafter reported by a petitioner arising from the commodity transactions at issue do not constitute taxable income to him.

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SECTION 108

Section 108 of Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 630, as amended by section 1808(d) of the Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2085, 2817.

SEC. 108. TREATMENT OF CERTAIN LOSSES ON STRADDLES ENTERED INTO BEFORE EFFECTIVE DATE OF ECONOMIC RECOVERY TAX ACT OF 1981.

(a) GENERAL RULE. – For purposes of the Internal Revenue Code of 1954, in the case of any disposition of 1 or more positions –

(1) which are entered into before 1982 and form part of a straddle, and

(2) to which the amendments made by title V of such Act [Economic Recovery Tax Act of 1981] do not apply, any loss from such disposition shall be allowed for the taxable year of the disposition if such loss is incurred in a trade or business, or if such loss is incurred in a transaction entered into for profit though not connected with a trade or business.

(b) LOSS INCURRED IN A TRADE OR BUSINESS. – For purposes of subsection (a), any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business.

(c) NET LOSS ALLOWED. – If any loss with respect to a position described in paragraphs (1) and (2) of subsection (a) is not allowable as a deduction (after applying subsections (a) and (b)), such loss shall be allowed in determining the gain or loss from dispositions of other positions in the straddle to the extent required to accurately reflect the taxpayer's net gain or loss from all positions in such straddle.

(d) OTHER RULES. – Except as otherwise provided in subsections (a) and (c) and in sections 1233 and 1234 of such Code, the determination of whether there is recognized gain or loss with respect to a position, and the amount and timing of such gain or loss, and the treatment of such gain or loss as long-term or short-term shall be made without regard to whether such position constitutes part of a straddle.

(e) STRADDLE. – For purposes of this section, the term "straddle" has the meaning given to such term by section 1092(c) of the Internal Revenue Code of 1954 as in effect on the day after the date of the enactment of the Economic Recovery Tax Act of 1981, and shall include a straddle all the positions of which are regulated futures contracts.

(f) COMMODITIES DEALERS. – For purposes of this section, the term "commodities dealer" means any taxpayer who –

(1) at any time before January 1, 1982, was an individual described in section 1402(i)(2)(B) of the Internal Revenue Code of 1954 (as added by this subtitle), or

(2) was a member of the family (within the meaning of section 704(e)(3) of such Code) of an individual described in paragraph (1) to the extent such member engaged in commodities trading through an organization the members of which consisted solely of –

(A) 1 or more individuals described in paragraph (1), and

(B) 1 or more members of the families (as so defined) of such individuals.

(g) REGULATED FUTURES CONTRACTS. – For purposes of this section, the term "regulated futures contracts" has the meaning given to such term by section 1256(b) of the Internal Revenue Code of 1954 (as in effect before the date of enactment of this Act).

(h) SYNDICATES. — For purposes of this section, any loss incurred by a person (other than a commodities dealer) with respect to an interest in a syndicate (within the meaning of section 1256(e)(3)(B) of the Internal Revenue Code of 1954) shall not be considered to be a loss incurred in a trade or business.

THE SPECIAL INTEREST TAX ACT OF 1984

HON. RICHARD L. OTTINGER
OF NEW YORK
IN THE HOUSE OF REPRESENTATIVES

Tuesday, July 24, 1984

Mr. OTTINGER. Mr. Speaker, I would like to bring to my colleagues' attention an article "Tax Dodgers Finding Shelter on Capitol Hill" from the July 2 Washington Post which roots out only one of the dozens of special interest tax breaks included in the final version of the Deficit Reduction Act of 1984. This bill, designed to reduce the $200 billion deficits by raising $50 billion over the next 3 years, is riddled with designer tax exemptions specifically tailored for some of the wealthiest corporations and individuals in the Nation. At a time when the deficits are threatening the financial stability of our Nation, it is unconscionable that Congress' tax writing committees can justify including such goodies which will cost the Federal Treasury billions of dollars.

The article's author, Mr. Jerry Knight, focused on a tax dodge for the constituents of members of the House Ways and Means Committee. This tax break has been afforded to 200 or so commodity traders in Chicago at a cost of $300 million to the Government. While this may seem like peanuts relative to the size of the Federal deficit, it translates into million dollar breaks for these individuals.

Yet while the wealthy Americans with friends on the tax writing committees are able to dodge taxes, most Americans will find themselves saddled with greater IRS bills. For instance, the extension of vital programs which promoted energy independence the solar and conservation tax credits were denied. Medicaid benefits, which provides health care for many of the Nation's needy, were tightened.

I urge my colleagues to read this article. Congress will no doubt have to draft another law in the 99th Congress to reduce

the deficit by a greater amount. Will this mean yet another box of goodies for the privileged of this Nation?

The article follows:

TAX DODGERS FINDING SHELTER ON CAPITOL HILL
(By Jerry Knight)

In the wee hours one morning a few days ago, when Congress was struggling to reduce the federal deficit, a bunch of millionaire tax dodgers proved that taxes are not as inevitable as death.

Not if you have friends who are writing the tax law.

With most of Congress and the media asleep, House Ways and Means Committee Chairman Dan Rostenkowski slipped into the tax bill a provision that gives a small group of accused tax cheaters—most from Rostenkowski's home state—privileges enjoyed by no other taxpayers.

The law of this land is that every taxpayer must bear the responsibility of proving the deductions claimed on the annual Form 1040 are legitimate. If the Internal Revenue Service questions the deduction you took for medical expenses, you have to prove you were sick.

But that rule of law will not apply to some 200 wealthy commodity traders who have been accused by the Internal Revenue Service of perpetrating one of the most costly tax dodges ever discovered.

For these privileged individuals, there will be a presumption that certain deductions they have claimed are legitimate. Only if the IRS can prove otherwise will the deductions be denied.

Outraged IRS and Treasury Department officials say that never before has Congress turned the tax law upside down for the benefit of a special-interest group.

Rostenkowski's midnight amendment could force the government to throw out court cases that took five years to prepare and that the IRS was all but certain to win. These are not small potatoes cases. The IRS says one Chicago commodity broker owes about $8 million and many of the 200 owe more than $1 million apiece. If all the cases have to be dropped, it will cost the government $300 million.

Worse yet, Rostenkowski's bailout means that two taxpayers who arranged virtually identical commodity deals to avoid paying taxes will be treated differently.

Ordinary investors will have to show they were trying to make money, not simply create losses to claim as tax deductions. But thanks to Rostenkowski, "professional commodity traders and persons who regularly trade commodity futures contracts" will be presumed to have a profit motive.

In many cases that distinction will mean the brokers who invented this tax dodge will get away with using it, but their clients will have to pay taxes.

The transactions at issue are so transparently designed only to avoid taxes that the IRS has won virtually every case it has taken to court challenging the deals known as "commodity tax straddles."

It takes a legal brief and a couple of charts to explain the details of even a simple straddle, but the basic idea is easy: At the end of the year you set up two parallel deals by simultaneously buying and selling commodity futures contracts. On one deal you will make money; on the other you will lose about the same amount. You do the losing deal in December and claim your losses on this year's taxes. You complete the profitable deal in January and recover all the money you lost. Of course you owe taxes on your January profits, but if you repeat the straddle every year, you can avoid paying indefinitely.

Structuring the straddle so you don't lose more money than you want to and are sure to regain your profits is not easy, but

Chicago commodity traders long ago mastered a virtually foolproof method known as the butterfly straddle.

The IRS caught wind of it and in 1977 issued a ruling casting doubt on all straddle deductions. In 1981 Congress closed the loophole tighter by requiring investors to report their December losses and their January profits as one transaction – whose net tax effect was zero.

By that time, the IRS had begun targeting returns, claiming large commodity trading losses, turning up billions of dollars of dubious deductions. Pending in tax court are $2 billion worth of straddle cases – $300 million against professional traders, the remainder from their clients.

One by one, the IRS has taken the taxpayers to court and ordered them to prove the commodity trades where made with a profit motive or pay up. Only last week Tax Court Judge Arthur Nims gave the government another major victory by ruling there was no profit motive in government securities investments arranged by a tax shelter promoter.

But while Judge Nims was nailing the barn door shut, Rostenkowski opened the way for the professional traders to escape without paying.

The tax committee's actions dismayed and demoralized government attorneys who spent years building their case against commodity tax cheating only to have their efforts destroyed by a political fix.

There is no doubt that Rostenkowski's amendment is a fix, but it is a legal fix. The way the game is played in Washington, you can do anything you want for your friend as long as you don't get caught taking a briefcase full of cash. Campaign contributions don't count.

Campaign cash routinely flows to influential tax writers from Chicago commodity traders. Local boy Rostenkowski gets their money even when he has no serious opposition; Ways and Means

member Marty Russo – another Illinois Democrat – is among the industry's leading advocates in the House. Democratic fund raiser Tony Coelho cultivates the Chicago crowd like prize tomato plants.

And this was a bipartisan fix. Bob Dole – representing Senate Republicans in the smoke-filled room – endorsed the bailout. Illinois Republican Sen. Charles Percy – running scared in his recollection campaign – gladly carried water for the mistreated millionaires among his constituents.

To their credit, Reagan administration representatives from the Treasury objected to the fix. But with a multibillion-dollar deficit bill at stake, they could not afford to publicly challenge the powerful committee chairmen over a pet loophole.

The commodity straddle fix is an indictment not only of the people who pass tax laws but also of the entire tax-writing process. So long as tax laws are drafted in midnight madness, these sordid little paragraphs will proliferate like Steven Spielberg's Gremlins. Shake some money on them and they multiply.

The incident also is an embarrassing example of the way the press covers the legislative process. The $800 million fix was reported as routine tax-writing by most media, including this newspaper. Only the Wall Street Journal warned in advance of the raid on the Treasury, and committee aides assured other reporters the warnings were needless because the provision would not be included. The New York Times decided the news was not fit to print, treating it not as a scandal, but as a joke about "commodes" and "twaddle" on its Washington Talk page. Twaddle indeed.

No. 91-628

Supreme Court, U.S.
FILED
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In the Supreme Court of the United States

OCTOBER TERM, 1991

CHARLES S. and BARBARA LERMAN, ET AL.,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether, under Section 108(b) of the Deficit Reduction Act of 1984, as amended by Section 1808(d) of the Tax Reform Act of 1986, a commodities dealer may deduct putative "losses" incurred from participation in sham commodity "straddle" transactions lacking economic substance.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	5
Conclusion	9

TABLE OF AUTHORITIES

Cases:

Bohrer v. *Commissioner*, 945 F.2d 344 (10th Cir. 1991)	2
Cook v. *Commissioner*, 90 T.C. 975 (1988)	7
Cook v. *Commissioner*, 941 F.2d 734 (9th Cir. 1991), cert. denied, No. 91-43 (Oct. 7, 1991)	4, 6, 7, 8
De Martino v. *Commissioner*, 862 F.2d 400 (2d Cir. 1988)	4, 6, 7, 8
Dewees v. *Commissioner*, 870 F.2d 21 (1st Cir. 1989)	2, 8
Friedman v. *Commissioner*, 869 F.2d 785 (4th Cir. 1989)	2, 8
Glass v. *Commissioner*, 87 T.C. 1087 (1986)	2, 3
Gregory v. *Helvering*, 293 U.S. 465 (1935)	5, 7
Keane v. *Commissioner*, 865 F.2d 1088 (9th Cir. 1989)	2, 8
Kielmar v. *Commissioner*, 884 F.2d 959 (7th Cir. 1989)	2
Killingsworth v. *Commissioner*, 864 F.2d 1214 (5th Cir. 1989)	2, 8
Kirchman v. *Commissioner*, 862 F.2d 1486 (11th Cir. 1989)	2, 8
Lee v. *Commissioner*, 897 F.2d 915 (8th Cir. 1989)	2
Ratliff v. *Commissioner*, 865 F.2d 97 (6th Cir. 1989)	8
Yosha v. *Commissioner*, 861 F.2d 494 (7th Cir. 1988)	2

Statutes: Page

Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 630:
§ 108, 98 Stat. 630 ..... 3, 4
§ 108(a), 98 Stat. 630 ..... 3, 5, 8
§ 108(b), 98 Stat. 630 ..... 3, 4, 5, 6, 7, 8
Tax Reform Act of 1986, Pub. L. No. 99-514, § 1808(d), 100 Stat. 2817-2818 3

Miscellaneous:

H.R. Rep. No. 426, 99th Cong., 1st Sess. (1985) 3-4, 6, 7

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A34) is reported at 939 F.2d 44. The opinion of the Tax Court (Pet. App. A38-A54) is unofficially reported under the caption *Fox* v. *Commissioner*, 56 T.C.M. (CCH) 863.

JURISDICTION

The judgment of the court of appeals (Pet. App. A35-A37) was entered on July 18, 1991. The petition for a writ of certiorari was filed on October 15, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. During 1975, 1976, and 1977, petitioners, who were assumed to be commodities dealers for purposes of the respondent's motion for summary judgment, participated in commodities tax straddle transactions on the London Metal Exchange.[1] Petitioners' transactions were designed to yield putative "losses" in the first year and offsetting "gains" in the next. By straddling the tax "losses" and "gains" over the two years, the objective was to derive tax benefits from transactions wholly lacking in economic substance. Because these transactions lacked economic substance, the Commissioner disallowed the deductions resulting from the claimed "losses," and the Tax Court upheld that determination.[2] Petitioners now acknowledge (Pet. 13; Pet. App. A3-A4) that the transactions for which they claim deductions were arranged solely for

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[1] Mrs. Lerman, Mrs. Fraites, and Mrs. Massey are petitioners only because they filed joint returns with their husbands (Pet. App. A41). Mr. Lerman, Mr. Fraites and Mr. Massey are hereinafter referred to as petitioners.

[2] Petitioners stipulated that their transactions were of the same type as the London option commodity straddle transactions held to be shams, devoid of economic substance, in *Glass* v. *Commissioner*, 87 T.C. 1087 (1986). *Glass* is the caption of some 1400 consolidated cases, and decisions in those cases have been affirmed by all of the courts of appeals that have considered them. *Dewees* v. *Commissioner*, 870 F.2d 21 (1st Cir. 1989); *Friedman* v. *Commissioner*, 869 F.2d 785 (4th Cir. 1989); *Killingsworth* v. *Commissioner*, 864 F.2d 1214 (5th Cir. 1989); *Yosha* v. *Commissioner*, 861 F.2d 494 (7th Cir. 1988); *Kielmar* v. *Commissioner*, 884 F.2d 959 (7th Cir. 1989); *Lee* v. *Commissioner*, 897 F.2d 915 (8th Cir. 1989); *Keane* v. *Commissioner*, 865 F.2d 1088 (9th Cir. 1989); *Bohrer* v. *Commissioner*, 945 F.2d 344 (10th Cir. 1991); *Kirchman* v. *Commissioner*, 862 F.2d 1486 (11th Cir. 1989).

the purpose of generating putative tax losses and thus lack economic substance. See *Glass* v. *Commissioner*, 87 T.C. 1087, 1153-1178 (1986); note 2, *supra*.

2. Taxpayers contend, however, that as commodities dealers, they are entitled to deduct the putative "losses" even though the transactions lacked economic substance. Petitioners' claim is based upon Section 108 of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 630, as amended by Section 1808(d) of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2817-2818. As amended, Section 108(a) provides that losses attributable to the disposition of one leg of a commodity straddle are deductible if incurred in a "trade or business" or in a "transaction entered into for profit." Section 108(b), as amended, provides that a "loss incurred by a commodities dealer * * * shall be treated as a loss incurred in a trade or business" (Pet. App. A4).

The Tax Court held that even though petitioners were presumed under Section 108 to be engaged in a "trade or business" as commodities dealers, Section 108 does not allow "losses" to be deducted when they are incurred in prearranged transactions that lack economic substance (Pet. App. A50-A51). Since offsetting gains had been prearranged, the court held that "petitioners' straddle transactions produced no losses to which the per se rule of section 108(b) can be applied." (Pet. App. A51). Because there were no "losses," Section 108(b), which applies only to "any loss" incurred by a commodities dealer, is not applicable (Pet. App. A4). This conclusion was supported by the legislative history of Section 108, which reflects that a deduction for losses incurred by dealers "would not be available in any cases where the trades were fictitious [or] prearranged" (Pet. App.

A50) (quoting H.R. Rep. No. 426, 99th Cong., 1st Sess. 911 (1985).

3. The court of appeals affirmed. The court agreed with the Tax Court that since the London option transactions were prearranged solely to generate tax benefits in the form of deductible losses, the transactions lacked economic substance and could not be recognized for tax purposes (Pet. App. A24). The court of appeals further held that Section 108 "cannot be applied to transactions lacking in economic substance because, in tax terms, a transaction lacking in economic substance cannot result in a 'loss'" (*ibid.*). Since there was no "loss," the court held that "section 108 does not even come into play" (*ibid.*). The fact that the transaction involved a commodities dealer was "neither a logical nor a statutorily-authorized reason to alter the economic substance rule" (Pet. App. A25). While noting that Congress, in amending Section 108(b), was willing to give up some tax revenue from straddle transactions due to the difficulty in proving a dealer's subjective profit motive, the court of appeals stated that (Pet. App. A30-A31):

> This * * * is a far cry from saying that Congress intended to allow dealers to take deductions based on straddle transactions totally devoid of any purpose beyond the generation of tax deductions and passed a statute by which there would be absolutely no inquiry into the substantial tax validity of such transactions.

The court further noted (Pet. App. A25-A29) that both the Ninth and Second Circuits had reached the same conclusion in *Cook* v. *Commissioner*, 941 F.2d 734 (9th Cir. 1991), cert. denied, No. 91-43 (Oct. 7, 1991), and *De Martino* v. *Commissioner*, 862 F.2d 400 (2d Cir. 1988).

ARGUMENT

The court of appeals correctly held that petitioners are not entitled to deduct their purported commodity tax straddle losses because these transactions lack economic substance. This decision does not conflict with any decision of this Court or of the other courts of appeals. Further review therefore is not warranted.

1. This Court has long held that transactions that lack economic substance will not be recognized for tax purposes. *Gregory* v. *Helvering*, 293 U.S. 465, 469 (1935). When a transaction represents "nothing more than a contrivance" in a scheme of tax avoidance, it will not be given effect. *Ibid.* Congress did not depart from this fundamental tenet of tax law in enacting Section 108(b).

As originally enacted, Section 108(a) provided that a loss on a straddle position was deductible if it was "part of a transaction entered into for profit" (Pet. App. A16 n.7). Section 108(b), in turn, provided dealers with a rebuttable presumption that their positions were profit motivated (*ibid.*). The Commissioner was thus free to introduce evidence to show that dealers did not have the requisite profit motive. In the Tax Reform Act of 1986, however, Section 108(a) was amended to provide that a loss on a straddle position is deductible if the loss is incurred either in a "trade or business" or in a transaction "entered into for profit" (Pet. 3-4). Section 108(b) was similarly amended to provide that "any loss incurred by a commodities dealer in the trading of commodities shall be treated as a loss incurred in a trade or business" (*ibid.*). The purpose of the amendment was to eliminate the need for the "inherent[ly] difficult[]" inquiry into the profit motive

of dealers for trades executed in the course of their customary business (H.R. Rep. No. 426, *supra*, at 910-911). The report of the House Ways and Means Committee makes clear, however, that, contrary to petitioners' contention (Pet. 16-37), Congress never intended that dealers who engage in straddle transactions that lack economic substance would be entitled to avail themselves of the provisions of Section 108(b). The report states (H.R. Rep. No. 426, *supra*, at 911):

> [T]he presumption would not be available in any cases where the trades were fictitious, prearranged, or otherwise in violation of the rules of the exchange in which the dealer is a member.

In light of this explicit expression of congressional intent, petitioners' argument that Congress meant to allow dealers to deduct putative losses from commodity trades where such transactions were prearranged to result in nothing more than tax losses is clearly without merit, and the courts of appeals have consistently rejected petitioners' contention. See *Cook* v. *Commissioner*, 941 F.2d at 738; *De Martino* v. *Commissioner*, 862 F.2d at 407. In enacting Section 108(b), Congress did *not* intend to give dealers a carte blanche to deduct artificial losses from commodity straddles that were, in substance, economic illusions. *Cook* v. *Commissioner*, *supra*; *De Martino* v. *Commissioner*, *supra*.

Petitioners err in contending (Pet. 41) that the court of appeals held that their trades lacked economic substance because they had no profit motive. The question whether a transaction has economic substance does not depend upon a subjective analysis of the taxpayer's motive but, instead, upon an objective analysis of whether the transaction has an economic

effect *other than* avoiding taxes. See *Gregory* v. *Helvering*, 293 U.S. at 469-470. Neither the Tax Court nor the court of appeals based its decision in this case on the absence of any profit motive on the part of the investors. Instead, the courts held that the transactions, viewed as a whole, were designed and executed to produce nothing other than tax benefits (Pet. App. A22, A23, A48).

Petitioners' further contention (Pet. 45-46) that the use of the word "prearranged" in H.R. Rep. No. 426, *supra*, "means 'fake' or 'phoney' trades or trades violative of the rules of the exchange" is simply wrong. If the Ways and Means Committee believed that a transaction that is prearranged is necessarily "fictitious", its application of the statute to trades that are either "fictitious, prearranged, or otherwise in violation of the rules of the exchange" (H.R. Rep. No. 426, *supra*, at 911) would have been unnecessary. The Committee evidently intended that Section 108(b) would be unavailable with respect to any transaction that lacks any real economic significance, whether because it is a factual sham or because it was prearranged to have no substantive effect other than the creation of tax benefits. See *Cook* v. *Commissioner*, 90 T.C. 975, 994 (1988) (Wells, J., concurring).

2. As petitioners apparently concede (Pet. 11), the decision in this case does not conflict with any decision of this Court or of any other court of appeals. Indeed, the only other courts to have considered this question have reached the same conclusion—that Section 108(b) does not allow a "loss" deduction for transactions that lack economic substance. See *Cook* v. *Commissioner*, 941 F.2d at 738; *De Martino* v. *Commissioner*, 862 F.2d at 407. In *Cook*, in which this

Court recently denied certiorari, the taxpayers had "invested" in the same type of London option straddle transactions at issue here. Because such trades involved a prearranged plan to create tax losses without any possibility that any genuine gain or loss would be realized, the court of appeals correctly concluded that they lacked economic substance and are not recognized for tax purposes. 941 F.2d at 736-737. Similarly, the Second Circuit held in *De Martino* that, in enacting Section 108(b), "Congress eliminated the profit motive inquiry in cases involving dealers because of the inherent difficulty involved in making such an inquiry, but it did not prevent inquiry into the economic substance of a dealer's commodity trading." 862 F.2d at 407.

The decision in this case also is consistent with numerous decisions holding that Section 108(a) has no application to commodity transactions that lack economic substance because no genuine "loss" has occurred. See, *e.g.*, *Keane* v. *Commissioner*, 865 F.2d 1088, 1093 (9th Cir. 1989); *Friedman* v. *Commissioner*, 869 F.2d 785, 791 (4th Cir. 1989); *Kirchman* v. *Commissioner*, 862 F.2d 1486, 1494 (11th Cir. 1989); *Killingsworth* v. *Commissioner*, 864 F.2d 1214, 1218 (5th Cir. 1989); *Ratliff* v. *Commissioner*, 865 F.2d 97, 99 (6th Cir. 1989). See also *Dewees* v. *Commissioner*, 870 F.2d 21, 36 (1st Cir. 1989). Further review therefore is not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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